

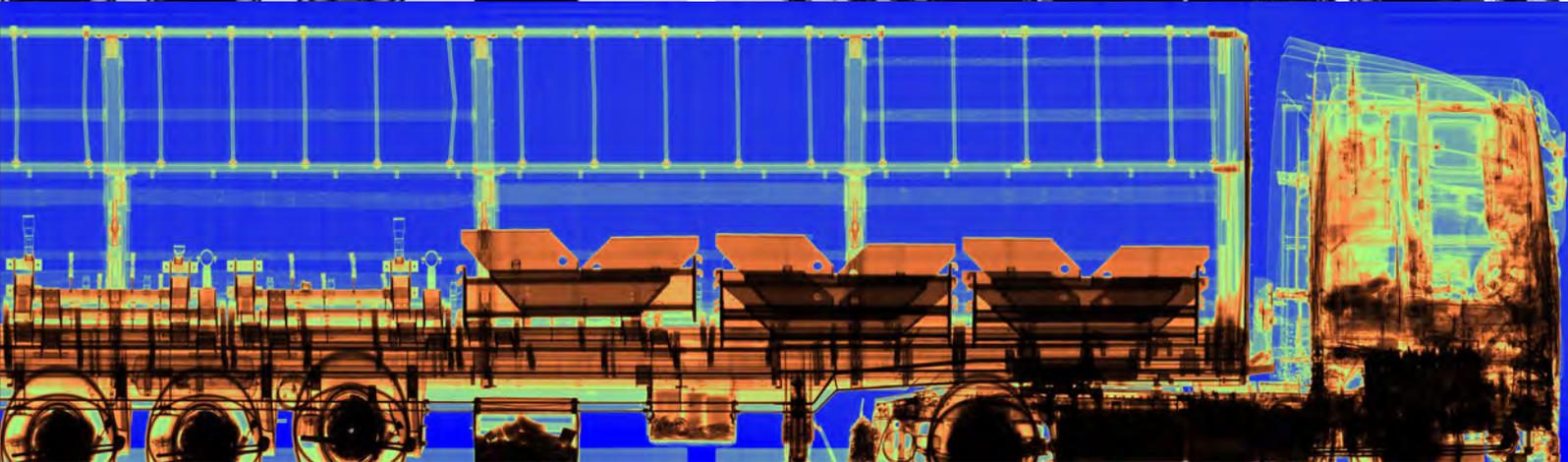


Whitehall Report 2-17

# On Tap Europe

Organised Crime and Illicit Trade in Tobacco,  
Alcohol and Pharmaceuticals

Clare Ellis



Royal United Services Institute  
for Defence and Security Studies

## About the On Tap Europe Series

According to Europol, commodity counterfeiting and illicit trade in substandard goods are major emerging criminal activities in the EU. The low risks and high profitability associated with illicit trade increasingly attract organised crime groups and the number of counterfeit products seized by law enforcement agencies across Europe continues to grow. The eighteen-month On Tap Europe study provides a comparative analysis of the role of organised crime in the illicit trade of tobacco, alcohol and pharmaceuticals across the EU, gathering evidence from a number of member states.

The six-part series explores the scale, methods and routes of these organised criminal networks, and identifies best practice in policy and law enforcement responses. This is the final report, which examines how these issues affect Europe as a whole; it features a series of recommendations for the European Commission, its agencies and EU member states.

On Tap Europe Series Final Report

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RUSI Whitehall Report 2-17, March 2017



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for Defence and Security Studies

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Whitehall Report 2-17 March 2017. ISSN 1750-9432

Printed in the UK by Stephen Austin and Sons, Ltd.

*Cover image: Scanner images of a truck at the port of Gdynia. Courtesy of the Customs Chamber in Gdynia, Poland.*

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# Acknowledgements

The author is very grateful to the subject matter experts across the EU who gave up their valuable time to support this study, particularly those from law enforcement, customs and other public bodies. The author would also like to thank all the members of the On Tap Europe project advisory board for their guidance and feedback.

Finally, thank you to RUSI colleagues, past and present, Calum Jeffray, Charlie Edwards, Andrew Glazzard, Edward Mortimer, Joseph Millis, Sarah Hudson and Charlie de Rivaz.



# Preface

**I**N POLAND, THE headquarters of the Police Central Bureau of Investigation in Warsaw (Centralne Biuro Śledcze Policji) are a hive of activity. During our meeting, officers are rushing along the corridor outside and our host has left on three occasions to take urgent phone calls: an illicit cigarette factory has been discovered. This is not uncommon in Poland – an estimated 41 illegal factories were discovered and dismantled in 2015 alone.

Across EU member states, production of illicit tobacco, alcohol and pharmaceutical products is increasing, as organised crime groups seek to reduce transport costs and the risks associated with transiting the EU's external borders. Often using crude materials, outdated machinery and in unsanitary conditions, these workshops range from small operations in a single room, basement or garage, to industrial-scale factories. It does not matter what commodity they produce – whatever public demand dictates.

Products are being stolen to meet this demand too. In recent years Italy has seen substantial thefts of pharmaceutical products from hospitals. Delivery vehicles have similarly been targeted, forced to stop in isolated locations, the driver is held at gunpoint while specific products are identified and removed from the consignment. Evidence suggests mafia involvement.

Illicit goods are also arriving in vast quantities through EU ports, accompanied by false documentation, their origin obscured by complex transit routes and their presence concealed beneath cover loads. Visiting the port of Algeciras in Spain, there is no immediate evidence of organised crime and no obvious collection of illicit goods. This activity is carefully hidden, but customs seizures confirm the threat.

Products are not just arriving by sea. Illicit trade infiltrates land border crossings too, with their steady streams of people, cars and trucks. Officers of the Romanian Border Police (Poliția de Frontieră) lead us to a large garage where a truck is waiting to be searched; intelligence suggests it contains illicit goods. The truck is filled with hundreds of small boxes and parcels and officers inspect each one in turn. They all contain counterfeit clothing.

The vast volumes of legitimate traffic entering and transiting the EU provide valuable cover for organised crime groups, who know that only a small percentage will be subject to inspection. The scale of post and courier traffic offers similar protection, and standing in the UK's international postal hub in Coventry, this quickly becomes apparent. Thousands of parcels enter the warehouse every day, passing along a maze of conveyer belts and into bags carried by fleets of forklift trucks. Without specific intelligence, locating illicit goods in these parcels seems an impossible task. But we know they are here, hidden in plain sight. The increasing exploitation of postal and courier services has been directly linked to the growth in e-commerce, with bespoke websites, auction sites and social media being used to sell illicit goods.

However, online purchases have not entirely replaced face-to-face sales from markets, private homes or street corners. The Bakalarska Street market in Warsaw is similar to the hundreds of other bazaars across Poland – and across many EU countries. Among the shoppers on each side of the street, a line of 20 to 30 figures in groups of two or three stand guard. It is virtually impossible to avoid walking through them, and a dozen voices all ask the same question: ‘Papierosy, cigarettes, cheap cigarettes?’ The seller first shows us the two or three empty packs he has on his person (in case we are undercover officers). He then leaves to retrieve our purchase from stock concealed behind a dustbin, in the boot of a car, or in the gap between two market stalls. The whole transaction takes little more than a minute.

Across the EU, these activities are taking place every day: illicit goods worth billions of euros are produced, imported, transported and sold, to both willing and unwitting customers. This is major organised crime on an international scale.

Organised crime thrives when it is invisible, and illicit trade is often carefully concealed among lawful pursuits or broken down into ‘little and often’ operations to slip under the radar or – at the very least – under the threshold for investigation.

Circumstances can also force law enforcement to focus elsewhere, and nowhere has this been more evident than in Greece. It is hard to miss the migrant camp as you drive into the port of Piraeus, six miles southwest of Athens. Tents and makeshift accommodation house around 1,000 inhabitants, all living outside the headquarters of the Hellenic Coastguard.

The unprecedented levels of irregular immigration to Greece came at a time when law enforcement agencies were already feeling the effects of significant financial austerity. The depletion of their resources and the need to focus on organised immigration crime is undoubtedly having a significant impact on both their intelligence coverage and their ability to adopt a strategic approach to tackling organised crime. This situation is understandable: as the Hellenic Coast Guard, why would you focus on barely visible forms of commodity smuggling when there is a much more visible humanitarian crisis to deal with on your doorstep? How can you begin to think about lower-level crimes such as illicit trade when lives are at risk in your seas?

Across the EU, law enforcement agencies face similar challenges of reduced resources and a subsequent need to ruthlessly prioritise activities. However, while the more violent and blatant elements of organised crime demand our attention, illicit trade is quietly capitalising, and has become one of the driving forces of organised crime activity in the EU.

# Executive Summary

**A**N OFFICIAL QUIETLY stamping paperwork; a lorry passing across internal EU borders; an innocuous parcel in a postman's van: this is what organised crime looks like in Europe. It is, of course, only one side of a multifaceted threat, but while the more violent elements of organised crime demand our attention, illicit trade is quietly capitalising: infiltrating our economies, bringing dangerous goods into our communities and diverting billions of euros away from EU governments.

The illicit trade is the epitome of modern organised crime in its reflection of legitimate business: groups are quick to recognise and respond to opportunities; they diversify their activities to minimise risk and maximise investment; they capitalise on new technologies; they build a network of contacts with varied expertise; and they cooperate with international partners.

Across Europe, this is not the organised crime threat that law enforcement was designed to tackle. Law enforcement is used to fighting strict hierarchical groups, but organised crime groups (OCGs) no longer have this structure; they are becoming 'loose, undefined and flexible networks'.<sup>1</sup>

But while law enforcement needs to evolve, there are also new allies to support them in their task. International bodies, industry regulators and affected sectors all have a role to play in reducing organised crime; as technology, infrastructure and regulation have advanced to facilitate legitimate business and cross-border trade, OCGs have found ways to similarly utilise these mechanisms, making them unintentional enablers of the illicit market. Efficient global commerce is an integral part of modern life, but the balance has not yet been found between facilitating trade and ensuring security.

The approach to prosecution and sanction across the EU also requires reform. At present, member states are ineffective in deterring both new entrants to illicit trade and repeat offenders. Fundamentally, the rewards are too high and the risks are too low. Until this balance can be altered illicit trade will remain a key aspect of organised crime activity and continue to be a threat across the EU.

This report is the culmination of an eighteen-month study conducted across five EU member states: Greece, Italy, Poland, Romania and Spain. The research team worked closely with law enforcement agencies, gaining some operational experience of both the threat and the methods undertaken to tackle it. In addition to desk research and fieldwork interviews with experts from the public and private sector, five workshops were held in the countries selected as case studies.

The country-level research has also been supplemented by further work to examine assessments of, and responses to, illicit trade at the European level. This included a two-day conference in

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1. Europol, *Exploring Tomorrow's Organised Crime* (The Hague: European Police Office, 2015), p. 12.

Brussels, examining the major themes raised by the research with representatives from law enforcement agencies, research organisations and European institutions, as well as the tobacco, alcohol and pharmaceutical industries.

## Recommendations

### European and International Institutions

1. **International standards must be established for free-trade zones (FTZs) to prevent their descent towards lawless territories that enable organised crime.** FTZs are being exploited by OCGs, who take advantage of their limited oversight to re-document shipments and conceal their true origin, or even to conduct parts of the manufacturing process. There are no enforceable international standards governing FTZs, officials described some FTZs as descending towards lawless territories. While FTZs are an important part of global trade, the balance has not yet been found between facilitating trade and ensuring security.

States are unlikely to act alone as national measures would undoubtedly reduce efficiency, potentially driving legitimate business to competing FTZs. Instead, clear, unambiguous global regulation is required. The World Customs Organization is ideally placed – but currently too weak – to impose international change and should be reformed, following the model provided by the Financial Action Task Force (FATF) in regulating the international financial system.

2. **Europol and the European Border and Coast Guard Agency (Frontex) should establish a dedicated centre to support member states in tackling corruption within the public sector.** Corruption at European borders is a critical enabler of illicit trade. Corrupt officials can undermine otherwise strict controls and enable the EU's outer defences to be easily breached by OCGs importing counterfeit or unlicensed goods. While some corrupt officials are prosecuted, there are reports of many more cases where corrupt officials were quietly transferred or dismissed and concerns that yet more remain undetected. The volume of illicit goods reaching EU markets would also seem to suggest that corruption is still a serious problem.

Europol and Frontex should jointly establish a dedicated anti-corruption centre to provide expert guidance in establishing vetting procedures, offer training for the detection of corruption among officials, and support member state investigations.

3. **Europol and the European Anti-Fraud Office (OLAF) should establish a joint review of intelligence-profiling in postal systems, given the tactics used by OCGs to obfuscate the origins of parcels.** OCGs are making increasing use of postal and courier systems, sending lower volumes of goods with greater frequency. Unable to scan the vast quantities of post entering the country, member states have instead employed intelligence-profiling to target parcels from locations considered high risk. However, OCGs are adapting to this strategy, transporting goods into the EU through other means before distributing them through the post, or specifically routing production through states with 'trusted' postal systems. In light of this evolving approach, strategies for detection at postal hubs need to be reviewed.
4. **The EU should review the regulation of private courier services.** As OCGs increasingly send goods in smaller shipments, and often directly to online customers, private couriers

are at risk of exploitation – just like national postal services. While new customers may see their parcels inspected by a courier, there are suggestions that returning customers may be more trusted, creating opportunities for OCGs to exploit.

In addition to major companies, there are reports of substantial numbers of small businesses offering courier services across member states, often established to provide a legitimate service between expats and their families. However, these services run a substantial risk of being used for illicit trade, with small vans regularly transporting hundreds of parcels across borders after collecting only minimal details from senders. There is also a broader security concern here, as many illegal items – not just tobacco, alcohol and pharmaceuticals – may be transported in this manner. Requirements for company registration, Know Your Customer (KYC) procedures and parcel inspection should be reviewed and strengthened.

5. **Sanctions for illicit trade must be reviewed and revised to increase consistency across member states.** Current sanctions for illicit trade do not act as an effective deterrent – they fail to deter both new entrants and repeat offenders. There is also increasing evidence that the sanctions within member states influence decisions by OCGs about where to conduct operations or which routes to take when transporting goods across the EU. Increased strength and increased consistency in the penalties for activity in the illicit trade should therefore be an important objective.

First submitted by the Commission in July 2012, the Protection of the Union's Financial Interests Directive includes provisions to directly address this objective; however, the draft text is the subject of disagreements within the Council and, at the time of writing, remains on hold.

6. **Measures must be adopted to protect consumers unwittingly involved in the illicit trade.** The internet is a primary enabler for the sale of illicit goods across Europe, particularly pharmaceutical products. While many consumers intentionally purchase goods illicitly, others are deceived into believing they are making a genuine purchase, with OCGs creating increasingly professional websites. OCGs are also adapting their methods for different audiences: lifestyle products are sold relatively openly on forums and social media, but there are also reports of OCGs targeting those with serious illnesses, posing as bereaved parties who want their loved one's remaining medicine to be of use.

Alongside work to reduce the demand for illicit products, steps must also be taken to protect those who purchase illicit products unwittingly. The introduction of the common EU logo for online pharmacies is a promising step; however, in order to be effective it must be accompanied by major public awareness campaigns – it can only protect those consumers who know to look for it.

## EU Member States

7. **Law enforcement agencies must develop internal strategies to combat illicit trade; they cannot focus solely on the border for detection and disruption.** There is growing evidence of illicit goods being manufactured within the EU in order to reduce both transport costs and the risks associated with transiting the EU's external border. While the border will always represent a key intervention point, intelligence-gathering and

disruption strategies must also encompass domestic activity, including goods being sent through the post.

8. **Law enforcement agencies should form temporary national task forces to tackle OCGs, following the format of international joint investigation teams (JITs).** Across the EU there is evidence of OCGs becoming active in multiple crime types. Flexible network structures produce agile groups who are quick to recognise and respond to market conditions, moving between crime and product types as opportunities arise. In contrast, law enforcement agencies often work in silos, with separate departments or agencies focusing on specific crime types.

National agencies tackling organised crime should mirror the flexible networked approach of their targets, following the format of international JITs. Investigators should be considered subject matter experts, able to join together as temporary task forces to identify the most efficient and effective way to disrupt an OCG. To facilitate this approach, they should be supported by a team of analysts, sifting intelligence to identify where investigations overlap. Such an approach would retain critical specialist knowledge, while ensuring efficient use of resources through early identification of overlapping investigations. Moreover, where appropriate, this approach could encompass experts from multiple agencies, such as police and customs.

9. **There is a need for a new model of public–private partnership across the EU to facilitate information sharing.** OCGs are increasingly establishing, infiltrating and simulating ‘legal’ businesses to obscure their illegal activities. The appearance of legitimacy can facilitate importing or exporting illicit goods across national borders and, in the case of shell companies, can also hinder attempts by law enforcement to identify the individuals profiting from the activities.

Member states must ensure that there are mechanisms in place to allow industry regulators and members of the private sector to share data and suspicions with law enforcement agencies to reduce vulnerabilities through early detection. Section 7 of the UK’s Crime and Courts Act 2013 offers an example of a successful non-coercive mechanism, permitting information sharing without imposing any undue obligations.

10. **National regulators must have a stronger role in combating crime in their sector, with clearly defined responsibility for performing due diligence in relation to both new and existing companies.** OCGs are also penetrating the specific sectors in which they are trading, registering for wholesale or retail licences in order to infiltrate legal supply chains. Regulated sectors at risk of infiltration by OCGs must ensure that stringent due diligence is applied to both new and existing companies. While in some cases this may require reform, if enacted, such reform has the potential to increase protection of legitimate supply chains and frustrate the activities of OCGs.
11. **Member states should establish dedicated prosecutors who specialise in organised crime and illicit trade.** In the fight against illicit trade, the successful prosecution of OCGs is crucial if the disruption of their activities and networks is to be substantial and enduring. The value of prosecutors who understand illicit trade within the context of organised crime was repeatedly highlighted during field research. Subject matter experts can be as valuable here as during investigations. The Italian experience in establishing

dedicated anti-mafia prosecutors (Direzione Nazionale Antimafia, or DNA) offers an example of the potential impact of specialised prosecutors in areas of complex crime.

12. **Asset recovery and financial penalties must be used to strengthen deterrence.** Fundamentally, illicit trade is attractive to OCGs because the financial rewards are vast and the associated risks are low. Strong, effective asset recovery regimes would help to alter this balance. Member states must ensure that law enforcement agencies have the authority, skills and resources to conduct financial investigations, and to freeze and ultimately recover criminal assets.

## Research

13. **There is a need to improve the data on which assessments of the scale and scope of illicit trade are made; wherever possible, comparable methodologies must be adopted to enable analysis across time, place, products and criminal methods; this is vital to inform the effective prioritisation of law enforcement resources.** Limitations in the methodologies available to estimate the scale of illicit trade must not become a barrier to their application. For example, while empty-pack surveys may not capture each element of the illicit tobacco market, they still offer a valuable indication of scale and scope; their use by law enforcement agencies alongside seizure data is testament to the potential value of even imperfect methodologies.<sup>2</sup>

Innovation in relation to other criminal products and methods should be similarly explored and supported, for example: measuring the chemicals in sewage and contrasting the result with the levels expected based on legal prescriptions;<sup>3</sup> or combining measures capturing difficult elements of the market, such as alcohol tax-gap estimates<sup>4</sup> and unexplained imports of industrial alcohol.<sup>5</sup> Given the evident value to industry in reducing the illicit trade, major companies should consider funding such endeavours.

14. **The demand for illicit goods must be tackled alongside the supply.** Social acceptability is a key enabler of the illicit trade across the EU, creating an environment in which demand for illicit products is tolerated. Research should be undertaken to understand what would be the most effective means of reducing the social acceptability, and therefore the demand, for illicit goods. There is a pressing need to understand what messages are effective, from what sources, through what medium and under which circumstances.

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2. During fieldwork conducted by the author, law enforcement agencies repeatedly referenced KPMG's 'Project Sun', which uses empty-pack surveys as part of its methodology.

3. See Bastiaan J Venhuis et al., 'Success of Rogue Online Pharmacies: Sewage Study of Sildenafil in The Netherlands', *British Medical Journal*, 2 July 2014, p. 349.

4. See HMRC, 'Statistics and Methodological Annexes Relating to Measuring Tax Gaps', 20 October 2016.

5. See Calum Jeffray, 'On Tap Europe: Organised Crime and Illicit Trade in Poland, Country Report', *RUSI Occasional Papers* (August 2016), pp. 14–15.



# Introduction

**N**EITHER THE EU, nor its member states, know the true scale of illicit trade. It is a largely invisible industry and includes a whole host of activities such as ‘counterfeiting (trademark infringements), piracy (copyright infringements), smuggling of legitimate products and tax evasion’.<sup>1</sup> Despite being incomplete, the figures associated with illicit trade are staggering.

Counterfeit and pirated products cost the EU as much as €85 billion in 2013,<sup>2</sup> and that is before losses from smuggling genuine goods or manufacturing unlicensed generic products are taken into account. This is not minor criminality, it is sophisticated organised crime on an international scale.

Indeed, illicit trade is the epitome of modern organised crime in its reflection of legitimate business: groups are quick to recognise and respond to opportunities; they diversify their activities to minimise risk and maximise investment; they capitalise on new technologies; and they build a network of contacts with varied expertise and cooperate with international partners.

Across Europe, this is not the organised crime threat that law enforcement agencies were designed to tackle. Organised crime groups (OCGs) are no longer strict hierarchical groups, but moving towards ‘loose, undefined and flexible networks’.<sup>3</sup> Where they are agile, law enforcement can be sluggish, clinging to structures and approaches that were designed to tackle an outdated threat.

But while law enforcement needs to evolve, there are also new allies to support them in their task. International bodies, industry regulators and affected sectors all have a role to play in reducing organised crime; as technology, infrastructure and regulation have advanced to facilitate legitimate business and cross-border trade, OCGs have found ways to similarly utilise these mechanisms, making them unintentional enablers of the illicit market. Efficient global commerce is an integral part of modern life, but the balance has not yet been found between facilitating trade and ensuring security.

The public too must share some responsibility. There is a clear disconnect between the increasing recognition among law enforcement agencies that illicit trade represents a significant aspect of organised crime activity and the public perception that it is a minor, victimless crime. This social acceptability creates an environment in which demand for illicit products is tolerated. If the EU is to have a substantial and sustained impact on illicit trade, this has to change.

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1. Interpol, ‘Trafficking in Illicit Goods and Counterfeiting’, <<https://www.interpol.int/Crime-areas/Trafficking-in-illicit-goods-and-counterfeiting/Trafficking-in-illicit-goods-and-counterfeiting>>, accessed 8 March 2017.
  2. OECD and the European Intellectual Property Office (EUIPO), *Trade in Counterfeit and Pirated Goods: Mapping the Economic Impact* (Paris: OECD Publishing, 2016), p. 76.
  3. Europol, *Exploring Tomorrow’s Organised Crime* (The Hague: European Police Office, 2015), p. 12.

Illicit trade may not be accompanied by the traditional violence of organised crime, or the visible presence of gangs on our streets, but the absence of such indicators should not be mistaken for a lack of effect. Illicit trade undermines confidence in legitimate business, brings dangerous products into our communities and denies EU governments billions of euros that could be funding schools and hospitals; instead, it puts that money into the pockets of the same OCGs that smuggle drugs, firearms and people. Illicit trade is the epitome of modern organised crime, and organised crime is never victimless.

## Research Rationale

As highlighted by Europol, ‘the distribution and production as well as the increasing demand and consumption of these [illicit] goods pose a serious threat to EU citizens’;<sup>4</sup> yet illicit trade is rarely considered a priority area of organised crime. This is perhaps in part due to limited information and a tendency to focus on those threats about which we have the greatest understanding.

However, there is growing evidence that OCGs dominate illicit trade. There are strong incentives for them to trade in counterfeit, unlicensed or untaxed products, with these crimes attracting lenient sanctions but offering substantial profits. Those profits are sometimes used as initial finance for other criminal activities, while at the same time diverting billions of euros from national treasuries and introducing potentially dangerous products to the market. This threat from illicit trade and the dominant role of OCGs demands further attention.

RUSI has therefore undertaken a comparative analysis of the role of organised crime in the illicit trade of tobacco, alcohol and pharmaceuticals across the EU to further increase understanding of a growing but often overlooked threat. Building on UK-based research, the regional focus of the study reflects the cross-border nature of the threat, which enabled the research team to examine both the international nature of OCG activity and the cooperation between member states in response.

## Methodology

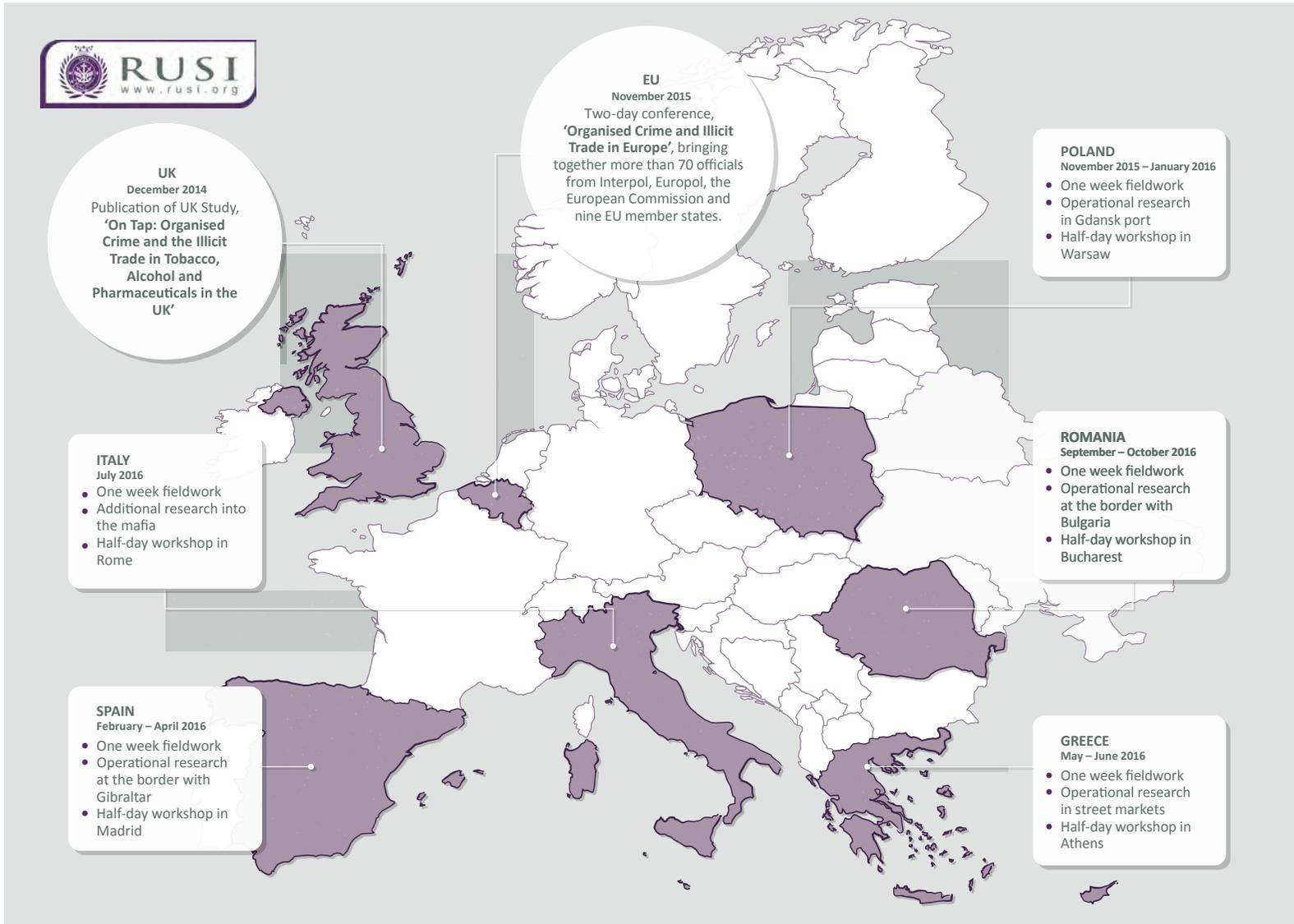
This is the first time such a study has been undertaken, with the research team working closely with law enforcement agencies across the EU to gain some operational experience of both the threat and the methods undertaken to tackle it.

The research team gathered evidence from five EU member states (Greece, Italy, Poland, Romania and Spain) to assess the scale, methods and routes involved in the illicit trade across source countries, transit hubs and destination markets, as illustrated in Figure 1. This report presents the overall findings from the research and offers a series of recommendations for the European Commission, its agencies and EU member states.

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4. Europol, *SOCTA 2013: EU Serious and Organised Crime Threat Assessment* (The Hague: European Police Office, 2013), p. 6.

Figure 1: Research Undertaken for On Tap Europe



The research for each country case study was split into three phases. The first consisted of a review of the existing academic literature, government policy documents, law enforcement strategies and private sector reports on organised crime and illicit trade.

In the second phase, a team of researchers spent a week conducting fieldwork, combining operational research with a series of semi-structured interviews with experts from industry, academia and law enforcement. These included the Police Central Bureau of Investigation in Poland (Centralne Biuro Śledcze Policji, or CBSP), the Customs Surveillance Directorate in Spain (Dirección Adjunta de Vigilancia Aduanera), the Hellenic Coast Guard in Greece, the Economic Police in Italy (Guardia di Finanza) and the General Inspectorate of Border Police in Romania (Politia de Frontiera Romana).

The final phase involved a half-day workshop, gathering together representatives from law enforcement agencies and research institutes, as well as the tobacco, alcohol and pharmaceutical industries. This allowed the researchers to validate their findings from the first two phases and to generate an informed discussion on likely future trends and policy implications. This methodology was repeated for each of the five case studies, with the findings presented in detailed country reports.<sup>5</sup>

The country-level research has been supplemented by further work to examine assessments of, and responses to, illicit trade at the European level: first, through reviewing relevant academic works and policy documents; second, through interviews with experts from international agencies; and third, through a two-day conference in Brussels, examining the major themes raised by the research with representatives from law enforcement agencies, research organisations and European institutions, as well as the tobacco, alcohol and pharmaceutical industries.

This report has three chapters. Chapter I examines the current understanding of the threat across Europe, considering the scope and scale of illicit trade in tobacco, alcohol and pharmaceuticals, alongside the prevalent routes and methods of OCGs. Chapter II focuses on the key enablers of illicit trade identified by the research, while Chapter III evaluates the response to illicit trade, from law enforcement investigation through to prosecution and criminal sanction. Finally, the conclusion presents the report's key findings and recommendations.

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5. Calum Jeffray, 'On Tap Europe: Organised Crime and Illicit Trade in Poland, Country Report', *RUSI Occasional Papers* (August 2016); Clare Ellis, 'On Tap Europe: Organised Crime and Illicit Trade in Spain, Country Report', *RUSI Occasional Papers* (January 2017); Calum Jeffray, 'On Tap Europe: Organised Crime and Illicit Trade in Greece, Country Report', *RUSI Occasional Papers* (February 2017); 'On Tap Europe: Organised Crime and Illicit Trade in Italy, Country Report', *RUSI Occasional Papers* (forthcoming); 'On Tap Europe: Organised Crime and Illicit Trade in Romania, Country Report', *RUSI Occasional Papers* (forthcoming).

# I. Understanding the Threat

**T**HE TRUE SCALE of illicit trade is unknown. Estimates address only limited aspects of illicit markets, and the availability of data varies substantially in relation to different products and different criminal activities.

The scope of illicit trade is much better understood, with investigations providing insight into OCG activities and methods. Smuggling is an intrinsic part of much illicit trade, facilitating the entry of goods into the EU and their transport across member states towards more lucrative markets. OCGs are establishing 'legal' businesses to obscure their activities, transporting high volumes of goods via container or truck, using cover loads,<sup>1</sup> false documentation and frequently altering transit routes. At the same time, the practice of high-frequency, low-volume trafficking is increasingly evident in the postal system. There is also a growing trend of illicit goods being manufactured within EU member states to reduce both transport costs and the risks associated with crossing the external EU border.

## The Scope and Scale of the Illicit Trade

### Scope

The term 'illicit trade' covers a range of activities that can be placed into two broad categories: the smuggling of genuine, counterfeit or unlicensed products into the EU and the illicit manufacturing of products within the EU's borders.

This report examines the illicit trade in tobacco, alcohol and pharmaceutical products. The most prevalent methods used by OCGs involved in this trade will be discussed in further detail below, but the overview provided here illustrates the scope of their activities. In terms of the illicit tobacco trade, there are three principal ways in which OCGs are involved:

- **Smuggling genuine products within the EU:** There are substantial price differentials across the EU, which create opportunities for considerable profit. Tobacco products are purchased at a low price in one country and smuggled into a more expensive market, evading the payment of excise duties and VAT. While some of this activity is conducted by opportunistic individuals, there is evidence indicating that much of it is coordinated by OCGs. Countries that share land borders are at obvious risk, but OCGs have repeatedly demonstrated a willingness to transit multiple countries in order to reach the most profitable markets.
- **Smuggling unlicensed or counterfeit products into the EU:** 'Cheap' or 'illicit whites' are cigarettes that are unlicensed for sale within the EU. In recent years, illicit whites have been a rapidly growing problem and in 2015 they are estimated to have accounted

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1. Cover loads are legitimate goods used to physically conceal illicit products.

for over one third of illicit cigarettes in Europe.<sup>2</sup> Counterfeits of genuine brands are also smuggled into the EU, often via containers, with China frequently cited as a major source country.

- **Manufacturing unlicensed or counterfeit products within the EU:** Illicit whites and counterfeit cigarettes are also increasingly produced within the EU, with factories ranging from single cutting machines operating in a garage, to industrial-scale production concealed in farm buildings.

Similarly, there are two principal ways in which OCGs are involved in the illicit alcohol trade:

- **Smuggling genuine products:** Mirroring the tobacco market, there are price differentials across the EU. Alcoholic beverages are purchased at a low price in one country and then smuggled into a more expensive market, evading the payment of excise duties and VAT. While some of this activity is conducted by opportunistic individuals, once again there is evidence indicating OCG participation in large-scale operations.
- **Manufacturing unlicensed or counterfeit products:** Illicit factories produce unlicensed generic brand alcoholic beverages or direct counterfeits of genuine brands. Illicit or counterfeit alcohol products often use denatured ethyl alcohol that was not intended for human consumption.

OCG activity is somewhat different in the illicit pharmaceutical trade, as there is no comparable incentive to evade duties and tariffs:

- **Exploitation of the parallel trade system:** The term 'parallel trade' refers to the practice in the EU of trading products that are bought cheaply in one part of Europe and sold in another part of the continent at higher prices. It is a legal part of the pharmaceutical market, but the system is vulnerable to abuse, and through it OCGs have been known to infiltrate the legitimate supply chain, selling counterfeit, unlicensed and expired products.
- **Smuggling unlicensed or counterfeit products into the EU:** Across the globe, the sale of medicinal products is governed by national authorities, which grant licences for sale. A product may therefore be legally sold in one country, but considered an illicit pharmaceutical in another. For example, Kamagra is an erectile dysfunction treatment produced primarily in India, where it is legal; however, it has not been granted market authorisation in the UK, where its trade remains illegal. OCGs are known to smuggle both counterfeit pharmaceutical products, and those that are not licensed for sale in the EU.
- **Manufacturing unlicensed or counterfeit products:** There is also evidence of OCGs manufacturing unlicensed generic brand products and counterfeits of genuine medicines in unregulated and often crude laboratories.

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2. KPMG, 'Project Sun: A Study of the Illicit Cigarette Market in the European Union, Norway and Switzerland: 2015 Results', June 2016, p. 7.

## Scale

The true scale of illicit trade is unknown. Moreover, the scale of the threat from different illicit products or from the different methods used by those engaged in illicit trade (such as smuggling genuine goods or counterfeiting) cannot be accurately compared, with data availability influencing, and potentially distorting, perceptions of the threat landscape. This makes trend analysis more challenging and hampers effective prioritisation of law enforcement activity and resources.

Assessing the scale of the illicit trade presented considerable challenges in each case study country. The relative scale of illicit markets is notoriously difficult to measure because of the covert, cross-border nature of criminal activities, and the differences in the volume and value of commodities such as tobacco, alcohol and pharmaceuticals.

Moreover, measurements typically draw either on seizure data or estimations of the volume circulating for sale. While useful, both measures offer only limited insight. The former partly reflects law enforcement and customs activity; an increase in seizures does not, therefore, necessarily indicate a growth in the scale of illicit trade, and can tell us nothing, by itself, about the volumes evading control. The latter – estimations of the volume circulating for sale – measures only the size of the destination market, offering no insight into illicit trade originating in, or transiting through, a country. As a result, estimations of the size of the illicit market within a state may not represent the full extent of such trade activities there. These challenges are further compounded when assessing the scale of illicit activity at a regional or international level.

Overall, the trade in counterfeit and pirated products is estimated by the OECD and the European Union Intellectual Property Office (EUIPO) to have cost the EU as much as €85 billion in 2013.<sup>3</sup> However, this figure highlights a further challenge when seeking to gather data: definitions of 'illicit trade' often focus only on limited aspects of the threat. The OECD and EUIPO study examines only intellectual property rights (IPR) infringement, excluding other forms of illicit trade.<sup>4</sup>

Similar challenges are encountered when gathering data in relation to specific products. A study by EUIPO recently estimated that, on average, the wine industry loses €530 million and the spirits industry €740 million each year as a result of counterfeiting, while the corresponding loss to public finances was estimated as €1.2 billion.<sup>5</sup> EUIPO has also estimated the loss to the

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3. OECD and EUIPO, *Trade in Counterfeit and Pirated Goods*, p. 76.

4. The OECD and EUIPO study focuses on counterfeit and pirated goods, which are defined respectively as 'tangible goods that infringe trademarks, design rights or patents' and 'tangible goods that infringe copyright'. Other aspects of illicit trade, such as the smuggling of genuine products into markets for which they were not intended, or the illicit production of 'generic' products that do not directly infringe IPR but are sub-standard or unlicensed, are therefore excluded. See OECD and EUIPO, *Trade in Counterfeit and Pirated Goods*, p. 16.

5. Losses to public finances were defined as 'the resulting losses of tax revenue by government, specifically income taxes and social contributions, corporate taxes, and indirect taxes such as

pharmaceutical industry through counterfeiting at €10.2 billion annually, with public finances losing a further €1.7 billion through lost taxes across the EU.<sup>6</sup> In both cases, the studies focused only on IPR infringement, again omitting other forms of illicit trade.

While such studies provide useful insights into the scale of defined aspects of illicit trade, without further context they have limited use in understanding overall scale or scope. Without comparable estimates with regard to smuggled genuine products, or illicitly produced generic goods, the ability to devise effective policy responses will remain limited.

Moreover, estimates at such a high level of aggregation obscure localised variations: while illicit cigarettes are estimated to represent just below 10% of the market across Europe,<sup>7</sup> they account for more than 20% of the market in Latvia<sup>8</sup> and Norway,<sup>9</sup> yet less than 2.5% in Portugal<sup>10</sup> and Slovakia.<sup>11</sup> Law enforcement and customs agencies in these countries would therefore perceive, prioritise and resource the threat very differently.

This consideration is particularly pertinent when analysing trends over time: across the EU the estimated scale of the illicit cigarette trade has remained relatively consistent in recent years, fluctuating between approximately 10% and 11% since 2010 (see Figure 2).<sup>12</sup> However, some member states have seen substantial changes, for example, Bulgaria saw a decrease from 30.7% to 11.6% in the same timeframe,<sup>13</sup> while Greece saw a rapid increase from 6.3% to a peak of 20.6% in 2014.<sup>14</sup>

Even within countries there can be significant variations. One of the key findings from research carried out for RUSI's Italy country report was the highly localised nature of illicit trade:<sup>15</sup> in Campania, in the south, the size of the illicit cigarette market is estimated to be 37%; only Friuli-Venezia Giulia in the northeast comes close (at 26%) with every other region less than 10% and most less than 5%.<sup>16</sup> This substantial disparity would certainly affect policy response.

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excise duties or VAT'. See EUIPO, 'The Economic Cost of IPR Infringement in Spirits and Wine', July 2016, p. 8.

6. Here losses to public finances were defined as 'the resulting losses of tax revenue by government, specifically income taxes and social contributions or corporate taxes'. See, EUIPO, 'The Economic Cost of IPR Infringement in the Pharmaceutical Industry', September 2016, p. 8.

7. KPMG, 'Project Sun: 2015 Results', p. 9.

8. *Ibid.*, p. 82.

9. *Ibid.*, p. 102.

10. *Ibid.*, 110.

11. *Ibid.*, 118.

12. *Ibid.*, 9.

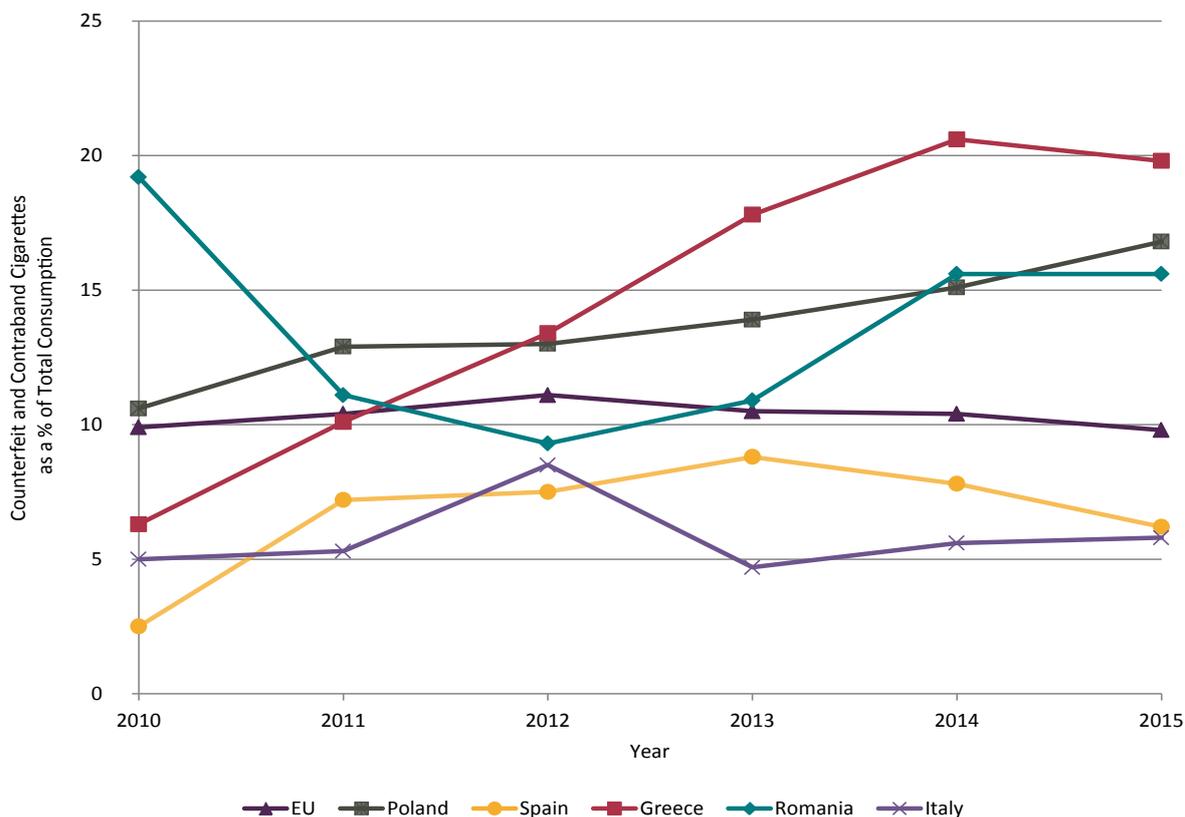
13. *Ibid.*, p. 28.

14. *Ibid.*, p. 64.

15. 'On Tap Europe: Organised Crime and Illicit Trade in Italy, Country Report'.

16. KPMG, 'Project Sun: 2015 Results', p. 80.

**Figure 2:** Variations in Trends of Illicit Cigarette Consumption in the EU



Source: KPMG, ‘Project Sun: A Study of the Illicit Cigarette Market in the European Union, Norway and Switzerland: 2015 Results’, June 2016.

Of greater importance than overall estimations are therefore detailed data at a lower level of aggregation. While of evident value for member states, this is equally the case for EU institutions with a role in tackling illicit trade: it is crucial to understanding the evolution of the threat across the region and therefore devise effective policy responses, allocate resources appropriately, and evaluate the impact of initiatives.

However, across Europe, such information is not necessarily available. RUSI’s research found substantial disparities in the quantity and type of information available for different products in each country; the data regarding illicit tobacco, both in terms of volume and detail, greatly exceed those for illicit alcohol and pharmaceuticals. The detail provided above outlining the fluctuations in the illicit cigarette market across time, within member states and across the EU, cannot currently be replicated for other products.

With regard to alcohol, the World Health Organization (WHO) offers estimates of ‘unrecorded’ alcohol in countries around the world, defined as ‘produced, distributed and sold outside [the]

formal channels'.<sup>17</sup> These estimates refer primarily to smuggled products on which duty has not been paid, or illicit production, including industrial alcohol. However, this figure is not a perfect measure as it also includes alcohol that has been legally produced at home for personal consumption. Moreover, as it does not distinguish between forms of illicit alcohol, it is not possible to draw any conclusions about the relative scale of different elements of the threat. Finally, the figures are also based on a 2010 survey, which is now a little out of date. However, despite these limitations, the WHO's figures at least offer a useful estimate in an area largely devoid of public data.

This is also supplemented by the EUIPO data outlined above, which offer estimations of the losses in different member states in relation to illicit wine, spirits and pharmaceutical products.<sup>18</sup> Although, as previously noted, these studies also omit significant elements of illicit trade.

In contrast, it is difficult to find any reliable data from which to estimate the size of the illicit pharmaceuticals market within EU member states, across the region, or internationally. The OECD notes that:

While a variety of estimates exist on the magnitude of the global counterfeit pharmaceutical trade, the veracity of the data utilised is highly questionable. Many estimates seem to be pulled from thin air, while those most cited and those from the most reliable sources have uncertain origins and questionable methodologies.<sup>19</sup>

Such inconsistencies make it difficult to assess the comparative scale of the threat from different illicit products and criminal activities (such as smuggling genuine goods or counterfeiting products), with data availability influencing, and potentially distorting, perceptions of the threat landscape. This makes trend analysis more challenging and hampers effective prioritisation of law enforcement activity and resources. Therefore the data on which such assessments are made need to improve and, in particular, wherever possible, comparable methodologies should be used to enable analysis across time, place, products and criminal methods.

Moreover, limitations in the methodologies available must not become a barrier to their application. The Project Sun<sup>20</sup> report prepared by KPMG is perhaps the most widely used reference for estimations of the illicit tobacco trade across Europe. One of the principle sources of data for this and other private sector studies are empty-pack surveys, which involve collecting discarded empty cigarette packs in order to analyse their authenticity and origin, either in independent or company laboratories. This method is not without flaws, however, and its accuracy has been called into question. For example, collection activities are focused

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17. WHO, *Global Status Report on Alcohol and Health 2014* (Geneva: World Health Organization, 2014). For WHO's definition of 'unrecorded alcohol', see p. 30.

18. EUIPO, 'The Economic Cost of IPR Infringement in Spirits and Wine'; EUIPO, 'The Economic Cost of IPR Infringement in the Pharmaceutical Industry'.

19. Kristina Lybecker, 'Illicit Trade in Counterfeit Medicines', in *Illicit Trade: Converging Criminal Networks* (Paris: OECD Publishing, 2016), p. 81.

20. KPMG, 'Project Sun: 2015 Results'.

in urban areas, therefore providing a somewhat distorted view of the market. It must also be remembered that the surveys do not collect data on loose or hand-rolled tobacco,<sup>21</sup> and therefore can produce estimates only of the illicit cigarette market, rather than the illicit tobacco market as a whole.

Nevertheless, such surveys are able to provide useful data on trends in illicit cigarettes over time, including the popularity of products and their origin. Indeed, it was notable during field research that law enforcement and customs agencies frequently referred to Project Sun, which they took into account alongside their own seizure data. Where similar methods can be developed for other products they should therefore be pursued, with limitations acknowledged but not necessarily viewed as a barrier to their application.

## Organised Crime: Groups, Routes and Methods

Field research in the case study countries confirmed that OCGs dominate the illicit trade in tobacco, alcohol and pharmaceuticals. While some small-scale activity may be undertaken by opportunistic individuals, the role of OCGs in coordinating, conducting and ultimately profiting from large-scale activity in illicit trade was repeatedly highlighted by the authorities during interviews, in official documents and by existing research.<sup>22</sup>

This is not surprising. Activities in the illicit trade are comparatively low risk, yet offer substantial profits.<sup>23</sup> Tobacco is an excellent example in this regard: it has low production costs, is lightweight and easy to transport, yet has high sale value and retains consistent consumer demand.<sup>24</sup> Moreover, as discussed in Chapter III, at present, member states are ineffective in deterring both new entrants to illicit trade and repeat offenders.

The evolution of OCGs towards ‘loose, undefined and flexible networks’<sup>25</sup> has also directly facilitated their activity in illicit trade. In contrast to closed groups, this network model

21. ‘Fine-cut’, ‘loose’ or ‘roll-your-own’ tobacco refers to tobacco that has been cut into small shreds, typically used to make self-made cigarettes by handrolling the tobacco into rolling paper or injecting it into filter tubes.

22. See, for example, INTERPOL, ‘Pharmaceutical Crime and Organized Criminal Groups: An Analysis of the Involvement of Organized Criminal Groups in Pharmaceutical Crime Since 2008’, 17 July 2014; UNICRI, ‘Counterfeit Medicines and Organised Crime’, 2012, pp. 88–89; Europol and the Office for Harmonization in the Internal Market, ‘2015 Situation Report on Counterfeiting in the European Union’, April 2015; Ministerio de Hacienda y Administraciones Públicas [Ministry of Finance and Civil Service], ‘Disposición 1836 del Boletín Oficial del Estado [Provision 1836 of the Official State Bulletin]’, No. 46, 23 February 2016, pp. 13,687–88; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], ‘Raport o stanie bezpieczeństwa w Polsce w 2014 roku [Report on the State of Security in Poland in 2014]’, p. 171; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], ‘Raport o stanie bezpieczeństwa w Polsce w 2010 roku [Report on the State of Security in Poland in 2010]’, p. 165.

23. Europol, *SOCTA 2013*.

24. Sharon Melzer and Chris Martin, ‘A Brief Overview of Illicit Trade in Tobacco Products’, in *Illicit Trade: Converging Criminal Networks*, p. 143.

25. Europol, *Exploring Tomorrow’s Organised Crime* (The Hague: European Police Office, 2015), p. 12.

engenders cooperation, which is extremely valuable for cross-border illicit trade. Moreover, it enables groups to draw on wider expertise in order to produce illicit products, obtain false documentation, or exploit EU tax regulations.

Illicit trade is also intertwined with broader organised crime activity. Field research found evidence of overlaps with activity such as the trafficking of narcotics or weapons, while Europol has also established links between illicit trade and the facilitation of illegal migration.<sup>26</sup> These links can take various forms. First, OCGs are known to use established smuggling routes for different products as opportunities arise. Moreover, profits from one crime area can be used as initial finance for other activities until they themselves become profitable – effectively providing ‘start-up capital’. With regard to illicit trade, there is evidence of it being initially funded by – and being used to fund – other areas of crime such as narcotics trafficking.<sup>27</sup>

Excise fraud and duty evasion are the exceptions: requiring very specific expertise, OCGs active in this area are less likely to conduct other forms of organised crime. However, even here there is evidence of agility and polycriminality (a group’s involvement in multiple crime types simultaneously), with the same methods applied to different taxed products as opportunities arise.

The principal methods used by OCGs to produce, import and transport illicit goods are outlined below, while the key enabling factors identified by this study are discussed in detail in Chapter II.

## Smuggling

Smuggling is an intrinsic part of much illicit trade, facilitating the entry of illicit goods into the EU and their transport across member states towards more lucrative markets.

Goods are often brought into the EU via shipping containers. The role of free-trade zones in facilitating this transport will be discussed in further detail in Chapter II, but they are frequently used by OCGs as a means to disguise the original point of manufacture, with containers being redocumented while inside the zone.<sup>28</sup> To further obscure the point of departure, containers often transit multiple jurisdictions, travelling via complex routes.<sup>29</sup> Moreover, these routes are frequently altered.<sup>30</sup>

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26. Europol and the Office for Harmonization in the Internal Market, ‘2015 Situation Report on Counterfeiting in the European Union’, p. 42; UNICRI, ‘Counterfeit Medicines and Organised Crime’, pp. 88–90.

27. See, Europol and the Office for Harmonization in the Internal Market, ‘2015 Situation Report on Counterfeiting in the European Union’, p. 44; and UNICRI, ‘Counterfeit Medicines and Organised Crime’, p. 90.

28. World Economic Forum Global Agenda Council on Organized Crime, ‘Organized Crime Enablers’, July 2012, p. 21; International Chamber of Commerce, Business Action to Stop Counterfeiting and Piracy (BASCAP), ‘Controlling the Zone: Balancing Facilitation and Control to Combat Illicit Trade in the World’s Free Trade Zones’, May 2013, p. 6.

29. OECD and EUIPO, *Trade in Counterfeit and Pirated Goods*, pp. 76, 82.

30. *Ibid.*, p. 82; UNICRI, ‘Counterfeit Medicines and Organised Crime’, p. 92.

To mask the nature of the goods being transported, OCGs use a range of methods, including cover loads of legal products to conceal illicit goods, switching the identifying markers on containers and simple misdeclaration.

Cover loads are often low-value legitimate goods listed on the documentation accompanying the transport and used to physically conceal illicit products in case of inspection. While the illicit products are unlikely to be uncovered through cursory visual inspection by the authorities, they remain vulnerable to scanning equipment or a thorough search. There is evidence of this technique being used in relation to illicit tobacco products from China,<sup>31</sup> and to conceal illicit pharmaceutical products from India. In May 2016, the Hellenic Police Financial Crime Unit, in cooperation with the US Drug Enforcement Administration, seized 26 million pills containing Tramadol, a prescription-only painkiller; the pills had been stacked behind boxes of household linen in a container from New Delhi and were estimated to be worth around \$13 million.<sup>32</sup>

**Box 1:** Case Study – Operation *Trileros*, Switching Papers Before Arrival

In November 2012, Spanish customs uncovered a plot to exchange the numbering and destination of two containers in order to smuggle illicit goods through the port of Algeciras in Spain. One container was transporting legal, low-value goods destined for Portugal, while illicit cigarettes were concealed within the other, destined for Gambia. Once the identifying markers of the containers had been switched, the cigarettes reached Portugal, declared to the authorities as equestrian equipment. However, alerted by their Spanish counterparts, the Portuguese authorities searched the container and seized more than 460,000 packs of cigarettes.

In November 2013, a second attempt was made to smuggle tobacco using this technique; the container of illicit tobacco was to be switched with one whose papers declared it to be transporting equestrian equipment, but in reality it contained low-value decorative gravel. Spanish customs intervened and seized a further 459,000 packs of cigarettes.

Nine members of the OCG involved were arrested, including two Bulgarian citizens, with further seizures of 4,180 packs of cigarettes, cash, vehicles, mobile phones and hardware. The ensuing investigations revealed that a third exchange had already been initiated; the container was intercepted and an additional 457,200 packs of cigarettes were seized. In total, almost 1.4 million packs of cigarettes were seized and prevented from reaching the illicit tobacco market in Spain.

*Source: Agencia Tributaria [Tax Agency], 'La Agencia Tributaria Desmantela una Trama Internacional de Contrabando Tras la Aprehesión de 1,4 millones de Cajetillas de Tabaco [The Tax Agency Dismantles an International Smuggling Plot Following the Seizure of 1.4 Million Packs of Tobacco]', 26 December 2013.*

31. Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 44.
32. *Reuters*, 'Greece Discovers Huge Quantity of Opiates, Investigates Islamic State Link', 6 June 2016; Tess Owen, 'The Islamic State May Have Gotten Caught Smuggling a Huge Shipment of Opiates to Libya', *Vice News*, 7 June 2016.

Alternatively, OCGs transport multiple containers, some of which contain wholly legitimate products. At some point during transit, the documentation and identifying markers are switched, enabling the illicit products to enter a European port with genuine but inaccurate documentation. The case study outlined in Box 1 (above) provides an illustration of this method in practice.

OCGs are also known to establish registered businesses to facilitate their cross-border activities, concealing their illicit nature behind a facade of legitimacy. Licensed businesses enable OCGs to obtain genuine documents to accompany imports and exports. In some cases, as illustrated in Box 2, these companies are also used to create a 'seller' and 'recipient' for goods in transit, creating the appearance of legitimate commerce where none exists.

**Box 2:** Case Study – Establishing Registered Companies for Illicit Trade

In 2014, the Hellenic Police in Athens received intelligence indicating that a multinational OCG was smuggling large quantities of illicit tobacco from North Africa and Asia into Greece.

The OCG had purchased a large number of forged Cypriot identities, which they had used to acquire Greek Tax Identification Numbers and establish limited liability companies. The sole purpose of these companies was to act as the sender and recipient for container shipping.

From 2011 to 2014, the OCG established fifteen such companies, using them to import 45 containers to Greece, principally through the port of Piraeus. They employed a complex methodology to conceal their activities, falsifying documentation and creating the appearance of legitimate business transactions.

Following investigation by the Greek authorities, 30 members of the OCG were arrested, including their leader. In total, almost 500 million cigarettes were seized, indicating lost taxes of more than €80 million.

*Source: Information provided to the author by the Hellenic Police.*

Similar methods are used to smuggle goods across land borders. Alongside maritime routes, transportation by road is particularly popular among OCGs, both to enter and to transit EU member states. Mirroring smuggling through seaports, OCGs create legitimate businesses to support their activities, enabling them to obtain documentation for imports into, and exports across, the EU. A number of OCGs are known also to have specifically established logistics and transportation companies, while others collaborate with complicit, and otherwise legitimate, businesses to further facilitate the movement of illicit goods.<sup>33</sup>

Cover loads are also used for road transport, offering at least limited protection in case of inspection. In Romania, officials cited examples that highlight the broad range of techniques encountered by law enforcement, including encasing illicit products in cement blocks, concealing them in hollowed timber logs, or hiding them under a cover load of rocks or gravel.

33. Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 44.

As with maritime routes to the EU, transit routes across the region are known to vary. Information gathered during field research indicates that one of the key factors in route selection is the level of risk, with OCGs avoiding countries with higher detection rates and stronger sanctions, even where this creates a more convoluted route.

Alongside the high-volume smuggling described above, smaller-scale trafficking of tobacco products is also seen across land borders. Individuals crossing at official checkpoints may conceal a small number of packets on their person, or alternatively carry much larger volumes across unofficial crossing points in fields or woodland. Modified vehicles may conceal products behind door panels, under seats or in the boot. While some of this activity is self-directed, with individuals selling their illicit products directly to consumers, much of it is coordinated by larger OCGs, which collate the produce for distribution.

This practice of high-frequency, low-volume trafficking is also carried out through the postal system. This form of smuggling is discussed in detail in Chapter II.

### **Illicit Production**

In addition to smuggling completed products into the EU, there is evidence of increasing production within member states in order to reduce transport costs and the risks associated with transiting the EU's external borders.<sup>34</sup>

With regard to tobacco, the risk associated with importing raw materials is substantially lower than for completed products, as principal components such as cigarette paper and cellulose acetate tow are not subject to comparable regulation.<sup>35</sup> Factories may produce counterfeit versions of legitimate brands, illicit whites and fine-cut or handrolling tobacco. The scale of production also varies. In some cases, it is only the final assembly of component parts that is conducted within the EU. In 2013, Belgian customs disrupted an international OCG that was smuggling counterfeit pouches, tax stamps and tobacco in separate shipments from China. They were ultimately destined for the UK, where they were intended to be assembled locally before sale.<sup>36</sup>

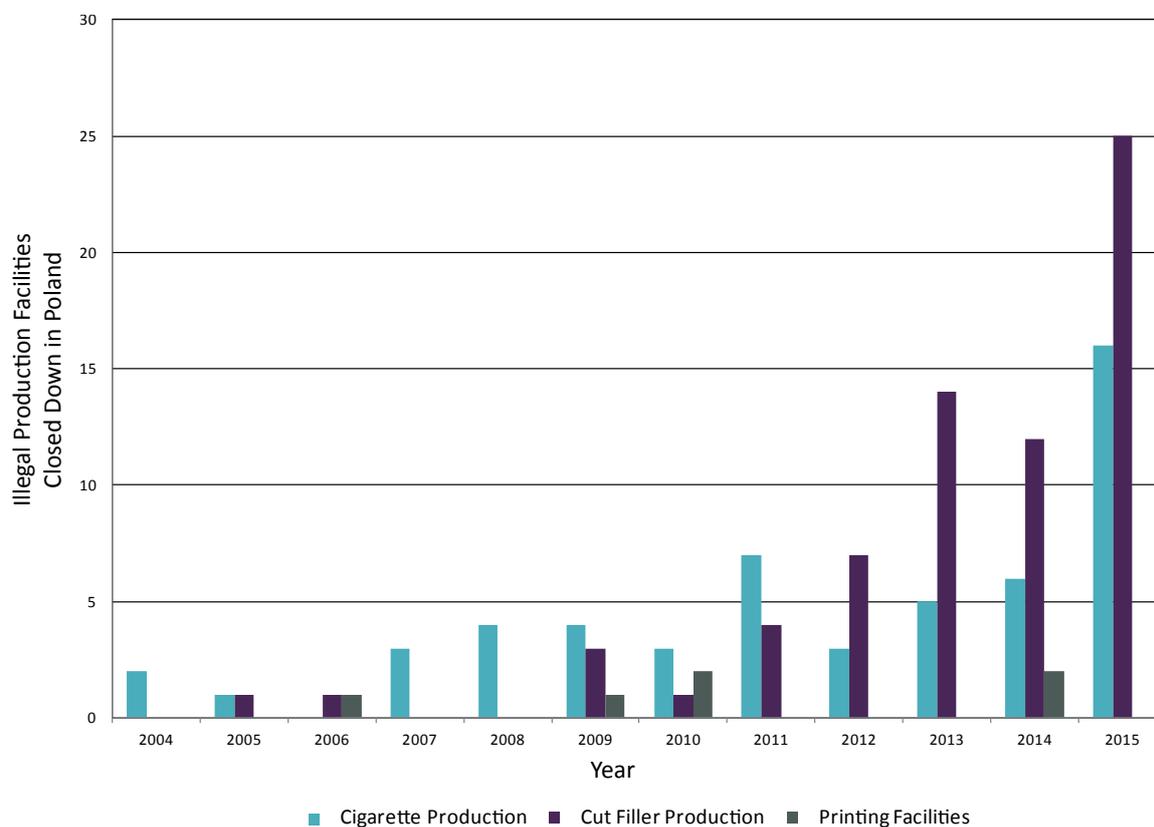
In other cases, industrial-scale factories are established to process raw tobacco, fill tubes and print packaging. Officials in two of our case study countries reported the discovery of substantial factories in recent years. Illicit production is considered an emerging trend in Spain, but already makes up a significant element of the threat in Poland, where an estimated 41 factories were closed down in 2015 alone (Figure 3).

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34. *Ibid.*, p. 17.

35. Transcrime – Joint Research Centre on Transnational Crime, *European Outlook on the Illicit Trade in Tobacco Products* (Milan: Transcrime, 2015), p. 59.

36. *Ibid.*, p. 28.

**Figure 3:** Illegal Production Facilities Closed Down Annually in Poland, 2004–15

Source: Industry estimates.

Establishing an illicit factory requires a financial investment. However, OCGs will often have already identified their intended market and built their supply chain. Distribution dictates production, so products are made to order with the health warnings in the correct language, or the counterfeit duty-free markings for the destination market already prepared.

With regard to raw materials, tobacco is grown extensively in some parts of Europe, with Italy, Greece, Spain, Poland and Bulgaria the principal producers, together accounting for almost 85% of Europe's harvest.<sup>37</sup> There is evidence that some European tobacco is used by OCGs, as illustrated by the case study in Box 3. However, OCGs also import vast quantities from outside the EU, for reasons of price, accessibility and in some cases quality. Officials interviewed for this report said that OCGs in Poland have been known to mix locally grown tobacco with raw product from overseas to improve the quality and taste.

Machinery and expertise are often readily available, particularly within countries where legitimate production has significantly reduced in previous decades. Where they are not locally

37. European Commission, 'Raw Tobacco – Production Statistics – 2014-2003 Harvests', DGAGRI/C.2, last updated 11 December 2015, pp. 4, 17.

available, OCGs will import machinery and workers from neighbouring EU countries, such as Bulgaria, or from countries further afield, including Ukraine and even Paraguay.<sup>38</sup>

OCGs are known to take extensive action to avoid detection. In Poland, authorities believe that illegal tobacco factories move regularly, perhaps as frequently as every three months. OCGs also use a variety of measures to protect and conceal their premises, as illustrated by the case study in Box 3.

**Box 3:** Case Study – Concealing Illicit Production

In late 2014, the Spanish National Police received intelligence from its Bulgarian counterparts regarding an OCG covertly transporting tobacco leaves and machinery from Bulgaria to illicit factories in Spain.

The ensuing investigation uncovered three premises in the provinces of Málaga, Toledo and Salamanca being used as factories. Production runs were carried out once every two months, and the OCG undertook extensive measures to conceal its activities. It insisted that workers live and sleep on the premises to limit opportunities for detection by the authorities. The factories were therefore equipped with beds, showers and a common area with a kitchen and dining room. The outer doors were locked from the outside, the windows covered and one factory even had devices to inhibit mobile phone signals. Each premise was also equipped with security cameras and soundproofing to conceal the noise of the machinery.

The production capacity in each of the three factories was estimated to be in excess of 11 million cigarettes a week.

An operation to dismantle the network in July 2016 led to the arrest of 22 people, 20 of them Bulgarians and two Spaniards. Almost 40 tonnes of chopped tobacco were seized, alongside 260,656 completed packs of cigarettes, 207,000 loose cigarettes, various machinery and packaging with health messages for different countries. The tobacco products seized had an estimated value of €7.1 million.

*Source: Agencia Tributaria [Tax Agency], 'Three Secret Tobacco Factories Dismantled and 39 Tons of Contraband Tobacco Seized', 11 July 2016.*

There is also evidence of illicit alcohol production in EU member states, of varying scale. OCGs may label unlicensed low-quality product as an expensive brand, or produce counterfeit or unlicensed products using industrial ethanol (a type of alcohol) that was never intended for human consumption.

Industrial ethanol has a number of legitimate applications, from household cleaning products to decontamination sprays. In contrast to alcohol intended for drinks production, it is exempt

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38. Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2014 roku [Report on the State of Security in Poland in 2014]', June 2015, p. 171.

from excise duty within the EU, which unintentionally creates opportunities for OCGs to make substantial profits if it is used to produce illicit wines or spirits. To prevent such exploitation, and ultimately protect consumers, there are regulations at both the national and EU level that require industrial ethanol alcohol to be 'denatured', that is rendered undrinkable through the addition of foul-tasting or foul-smelling chemicals. A blue or purple dye is often also added so that the product can be easily recognised.

However, OCGs can take steps to filter out and remove these denaturants by, for example, using diatomaceous earth or simply adding forms of bleach. The resultant products are potentially extremely harmful due to the nature of the alcohol used and the often unsanitary production facilities. Moreover, there have also been instances of methanol industrial alcohol being used in error. Highly toxic once metabolised by the human body, methanol poisoning can cause blindness and death, as was highlighted in the Czech Republic in 2012 when dozens of people died and many more suffered permanent health damage.<sup>39</sup>

The illicit alcohol products are sold as either counterfeits of genuine brands or are unlabelled. When producing counterfeits, the forgery goes beyond the product's label, often including bottle designs and caps. Alternatively, OCGs may refill genuine bottles. In Romania, there are indications that staff in bars and clubs are sometimes complicit in this activity, not only providing empty bottles, but taking care when removing plastic wrappers so that they can be replaced.

**Box 4: Case Study – Counterfeit Champagne**

In 2013, the Carabinieri's dedicated unit for the protection of health (Nuclei Antisofisticazioni e Sanità dell'Arma, NAS) disrupted a supply of counterfeit champagne in Italy.

Searches uncovered bottling equipment, bottles, caps and large quantities of counterfeit labels of established brands including Moët & Chandon and Veuve Clicquot. The seized products would have provided a profit of at least €2 million for the OCG had they been sold through the illicit market.

*Source: Ministero della Salute [Ministry of Health], 'Sicurezza Alimentare, Nas di Napoli Sequestrano Bottiglie di Champagne False per un Valore di 400mila Euro [Food Security, NAS in Naples Seize Fake Champagne Bottles with a Value of 400 Thousand Euros]', press release, 13 December 2013.*

Illicit pharmaceutical products are also produced within EU borders. The 'laboratories', far from being vast, sterile rooms with sophisticated equipment, are in fact often located in apartments, houses or garages, with crude, outdated and unsanitary equipment. Active ingredients are purchased from various countries, although China and India are often cited as the principal

39. Sergey Zakharov et al., 'Czech Mass Methanol Outbreak 2012: Epidemiology, Challenges and Clinical Features', *Clinical Toxicology* (Vol. 52, No. 10, 2014), pp. 1,013–24.

sources.<sup>40</sup> Due to their size, they may be easily imported into the EU via the postal system and then used to produce either illicit, generic brand products or counterfeits of known products.

As with illicit alcohol, in the production of counterfeit pharmaceutical products, OCGs pay particular attention to the packaging and labelling in order to deceive unwitting customers.<sup>41</sup> Indeed, it is noteworthy that in the case study outlined in Box 6, much of the machinery seized was used for producing packaging and labels.

#### **Box 5: Case Study – Counterfeit Spirits**

In July 2008, an alcohol factory was discovered in Szczecin, a Polish city close to the German border. Authorities seized around 33,000 litres of pure alcohol and 8,000 litres of partly decontaminated industrial alcohol on the suspicion that they were being used to produce counterfeit vodka (Smirnoff, Glen's and Kirov brands).

A full-scale production line had allegedly been established, with counterfeit labels, holograms and caps. The factory was thought to be capable of producing 24 bottles per minute. All those arrested were Polish nationals, although authorities also suspected that there was a link with a bottling factory in London in the UK.

*Source: Calum Jeffray, 'On Tap Europe: Organised Crime and Illicit Trade in Poland, Country Report', p. 25.*

#### **Box 6: Case Study – Counterfeit Pharmaceutical Products**

In September 2016, Poland's Central Bureau of Investigation (CBSP) announced that it had dismantled a large illicit factory producing counterfeit pharmaceutical products. Production equipment was concealed in hidden rooms on the premises. In total, officers found 48 machines, including those for mixing ingredients, pressing tablets and printing labels.

The investigation suggests that semi-completed products were imported from China, with the supply chain also transiting through Greece, Romania and the UK. The counterfeit products were principally sold over the internet. In addition to the machinery, officers seized 100,000 erectile dysfunction pills and 430,000 vials of anabolic steroids worth an estimated 17 million zlotys (approximately €4 million). Overall, CBSP estimated that the factory had produced illicit pharmaceutical products worth 'at least tens of millions of zlotys'.

*Source: Centralne Biuro Śledcze Policji [Central Bureau of Investigation], 'Policjanci CBŚP Zlikwidowali Największą na Świecie Nielegalną Fabrykę Sfałszowanych Anaboliów i Leków na Potencję [The CBŚP Dismantle the World's Largest Factory for Counterfeit Anabolic Steroids and Impotence Drugs]', press release, 20 September 2016.*

40. Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 21.

41. UNICRI, 'Counterfeit Medicines and Organised Crime', pp. 91–92.



## II. Enablers of the Illicit Trade

**O**CGS ACROSS EUROPE are quick to recognise and exploit opportunities. As technology, infrastructure and regulation have evolved to facilitate legitimate business and cross-border trade, OCGs have found ways to exploit these mechanisms and thereby make them unintentional enablers of the illicit market. To date, the abuse of such mechanisms has largely only been considered once exploitation is apparent, with law enforcement agencies retrofitting countermeasures. However, security must be considered from the outset, such is the scale and impact of organised crime activity associated with illicit trade.

The research for this report highlighted five key enablers of the illicit trade across Europe:

- **Corruption:** Corruption at European borders is a critical enabler of illicit trade. Corrupt officials can undermine otherwise strict controls, and enable the EU's outer defences to be easily breached by OCGs importing counterfeit or unlicensed goods.
- **Free-trade zones:** Free-trade zones are exploited by OCGs who take advantage of their limited oversight to re-document shipments and conceal their true origin, or even to conduct parts of the manufacturing process.
- **Postal and courier services:** OCGs use postal and courier systems to transport illicit products, sending lower volumes of goods with greater frequency. Small courier companies represent a growing risk, with small vans regularly transporting hundreds of parcels across borders after only collecting minimal details from senders.
- **The internet and social media:** The internet is a key enabler for the sale of illicit goods across Europe, in particular pharmaceutical products. While many consumers intentionally purchase goods in this manner, others are deceived into believing they are making a genuine purchase, with OCGs creating increasingly professional websites.
- **Social acceptability:** Social acceptability is an important enabling factor for illicit trade across the EU, creating an environment in which demand for illicit products is tolerated.

In addition to these overarching factors, some aspects of EU regulation were found to enable aspects of illicit trade more narrowly and are also discussed below.

### Corruption

Corruption has the potential to facilitate illicit trade at any stage in the supply chain, but it is perhaps of greatest concern at the border.<sup>1</sup> Although there is evidence of increasing illicit production within the EU, smuggling remains a major part of illicit trade and therefore borders are a primary intervention point. However, corrupt officials can undermine otherwise strict

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1. Corruption of individuals within the private sector may also facilitate illicit trade. For example, manufacturers, distributors or brokers may facilitate the diversion of genuine products or the infiltration of illicit goods into the legitimate supply chain.

controls, and enable the EU's outer defences to be easily breached by OCGs importing counterfeit or unlicensed goods.

Corruption at the border can take various forms, from passing information to OCGs about patrol routes or customs checks, to actively assisting in the safe passage of vehicles or shipments, omitting inspections and clearing them for entry.<sup>2</sup>

Research conducted by the Center for the Study of Democracy (CSD) found that 'trafficking in cigarettes has become one of the biggest and fastest growing drivers of corruption along the EU's eastern land borders, as well as at some major ports in Western Europe'.<sup>3</sup> Contrasting illicit trade with narcotics trafficking, the report highlighted the relative absence of social stigma as an enabling factor alongside the limited risk in case of detection: while officials convicted of facilitating drug traffickers are likely to receive prison sentences, those facilitating the illicit tobacco trade are unlikely to be treated with such severity.<sup>4</sup>

This message resonated during fieldwork interviews. Concerns were raised regarding corruption at both land borders and seaports, but caution was urged in examining prosecution statistics for evidence of the scale of the problem. In many cases, officials are transferred to less vulnerable posts or dismissed, but prosecutions are comparatively rare. This is not necessarily indicative of a tolerant attitude, but instead of the difficulties in proving such charges: substantiating illegal intention rather than incompetence can be challenging.<sup>5</sup>

The scale of corruption at the EU border may be difficult to quantify, but its role in facilitating illicit trade is becoming increasingly difficult to ignore. There are a number of cases where corruption has been proven to have facilitated illicit trade. In Romania, for example, corrupt officials from customs and the border police were sentenced to between four and five years' imprisonment after it was established that they had been assisting an international OCG to smuggle counterfeit perfume and cigarettes into the EU.<sup>6</sup> In Greece, officers of the Hellenic Coast Guard were arrested for providing information to OCGs that enabled them to smuggle illicit tobacco into the country (see Box 7), while Albanian OCGs are similarly known to bribe police and customs officials so that they will not interfere with the transport of illicit tobacco.<sup>7</sup>

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2. Center for the Study of Democracy (CSD), 'Study on Anti-Corruption Measures in EU Border Control', March 2012, pp. 46–47.

3. *Ibid.*, p. 46.

4. *Ibid.*

5. Atanas Rusev, *Human Trafficking, Border Security and Related Corruption in the EU*, DCAF Brussels Migration and the Security Sector Paper Series (Brussels: DCAF Publishing, 2013), p. 9; CSD, 'Study on Anti-corruption Measures in EU Border Control', p. 47.

6. Information provided to the author by the General Inspectorate of the Romanian Border Police (Inspectoratul General al Poliției de Frontieră).

7. Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 42.

**Box 7: Case Study – Corruption as an Enabler of Illicit Trade**

In March 2011, intelligence suggested that four international OCGs were importing vast quantities of illicit tobacco into Greece with the assistance of corrupt officers from the Hellenic Coast Guard.

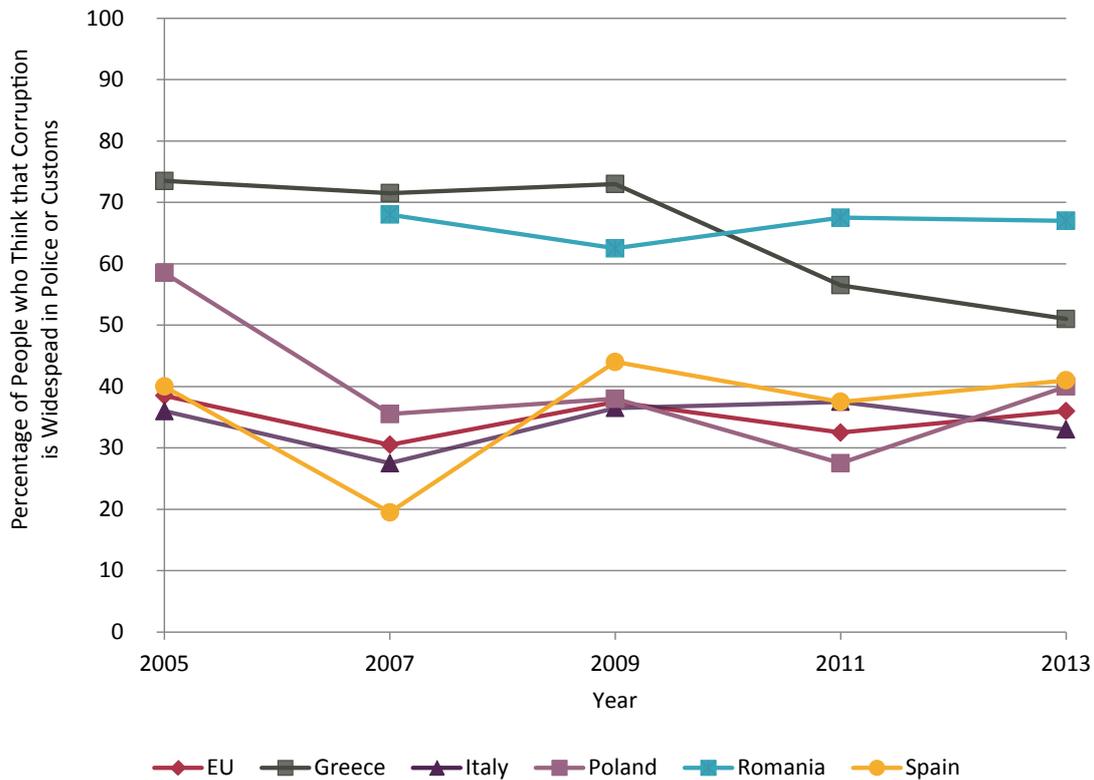
Guided by information from the officers, the OCGs unloaded their cargo in secluded beaches away from coast guard patrols, loading them onto trucks for onward transport to other EU countries or for distribution in Greece. It was estimated that the smuggling activities of these OCGs equated to tens of millions of euros in lost taxes.

*Source: Ministry Of Citizen Protection and Hellenic Coastguard, 'Σε εξέλιξη ευρείας κλίμακας κοινή επιχείρηση της ΕΑ και του ΛΣ – ΕΛΑΚΤ, σε συνεργασία με την ΕΥΠ για την εξάρθρωση τεσσάρων (4) εγκληματικών οργανώσεων διακίνησης μεγάλων ποσοτήτων λαθραίων τσιγάρων [Ongoing Large-Scale Joint Venture of HP and the Hellenic Coastguard in Collaboration With the NIA for Dismantling Four (4) Criminal Organisations Smuggling Large Quantities of Cigarettes]', press release, 8 November 2011; Ministry Of Citizen Protection and Hellenic Coastguard, 'Συνέχεια ενημέρωσης για εξάρθρωση τεσσάρων (4) εγκληματικών οργανώσεων διακίνησης μεγάλων ποσοτήτων λαθραίων τσιγάρων [Update on the Dismantling of the Four (4) Criminal Organisations Smuggling Large Quantities of Cigarettes]', press release, 11 November 2011.*

Moreover, during interviews with the author, officials suggested that each prosecuted and publicised case is accompanied by many more where officials were quietly transferred or dismissed. It should also be noted that numerous cases are believed to remain undetected, contributing to the substantial volumes of illicit tobacco, alcohol and pharmaceuticals that continue to evade detection and reach EU markets.

Interviews with EU citizens have also revealed concerns about corruption. Eurobarometer surveys conducted in 2005,<sup>8</sup> 2007,<sup>9</sup> 2009,<sup>10</sup> 2011,<sup>11</sup> and 2013<sup>12</sup> have all concluded that a majority of EU citizens believe corruption to be a 'major problem for their country'. In 2013, more than one-third specifically believed that corruption was likely to be 'widespread' within their police or customs authorities (Figure 4), with the most concerning results in Bulgaria and Romania (both 67%), Lithuania (63%), Latvia (58%) and Croatia (57%).<sup>13</sup>

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8. European Commission, 'Opinions on Organised, Cross-Border Crime and Corruption: Summary', Special Eurobarometer, March 2006.
  9. European Commission, 'The Attitudes of Europeans Towards Corruption: Summary', Special Eurobarometer 291, April 2008.
  10. European Commission, 'Attitudes of Europeans Towards Corruption: Full Report', Special Eurobarometer, November 2009.
  11. European Commission, 'Corruption: Report', Special Eurobarometer 374, February 2012.
  12. European Commission, 'Corruption: Report', Special Eurobarometer 397, February 2014.
  13. *Ibid.*

**Figure 4:** Public Perception of Corruption in Police and Customs across the EU

Sources: European Commission, 'Corruption: Report', Special Eurobarometer 397, February 2014; European Commission, 'Corruption: Report', Special Eurobarometer 374, February 2012; European Commission, 'Attitudes of Europeans Towards Corruption: Full Report', Special Eurobarometer, November 2009; European Commission, 'The Attitudes of Europeans Towards Corruption: Summary', Special Eurobarometer 291, April 2008; European Commission, 'Opinions on Organised, Cross-Border Crime and Corruption: Summary', Special Eurobarometer, March 2006. Note that in the surveys corruption is defined as the giving and taking of bribes and the abuse of power for personal gain.

While there are numerous factors that may create personal vulnerability to corruption, there are also institutional factors that can increase the risk of corruption flourishing. Giving individual officers responsibility for multiple stages of the clearing process was cited during interviews as a key concern, as one corrupt officer can facilitate the evasion of multiple control mechanisms. There are therefore institutional responses that can help to reduce the risk of corruption, including preventative measures, such as separating responsibility for different stages of the clearing process and establishing clear accountability and oversight mechanisms. Vetting is also an important tool during recruitment and periodically throughout employment. While such measures may appear self-evident, the persistence of corruption at EU borders suggests that they require reiteration.

It also suggests that this is an area in which member states require further guidance and support. The European Commission has been vocal in the fight against corruption: it has established a regular reporting mechanism to assess the implementation of policies across member states,<sup>14</sup> and launched the 'Experience Sharing Programme', bringing national representatives together through a series of workshops.<sup>15</sup> However, such measures have not yet focused on the corruption of law enforcement at the operational level, instead examining political and administrative corruption more broadly.

Frontex, the European Border and Coast Guard Agency, has provided capacity-building and training to its members, which includes raising awareness of corruption;<sup>16</sup> however, this action appears to be extremely limited in scope. Similarly, Europol supports law enforcement operations and investigations, but in 2012 it was estimated that only 2% of such cases related to corruption.<sup>17</sup>

There is no comprehensive, coordinated programme at the EU level to assess the scope, scale and impact of corruption at the border; nor is there guidance for member states on detection, investigation or prevention. Across the EU there are thousands of dedicated law enforcement professionals, but until comprehensive and concerted action is undertaken, the corrupt minority will continue to undermine their work.

## Free-Trade Zones

Over the past three decades, free-trade zones (FTZs) have grown dramatically and become an integral part of global trade.<sup>18</sup> Created by governments to stimulate trade, attract investment and generate employment, FTZs facilitate transit and transshipment operations in international trade, offering warehousing, storage and distribution facilities without any requirement to pay national duties and taxes.<sup>19</sup> This is accompanied by simplified administrative procedures, creating logistical benefits alongside the direct financial advantages.<sup>20</sup>

However, these simplified administrative procedures are often accompanied by limited oversight. In 2010, the Financial Action Task Force (FATF) identified systemic weaknesses that render FTZs vulnerable to exploitation by OCGs, including: relaxed oversight by competent domestic authorities; weak procedures to inspect goods and register legal entities, including inadequate record-keeping and IT systems; and a lack of coordination and cooperation between zone and customs authorities.<sup>21</sup>

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14. The first 'EU Anti-Corruption Report' was published by the European Commission in February 2014.

15. European Commission, 'Anti-Corruption Experience Sharing Programme', 16 June 2016, <[https://ec.europa.eu/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/experience-sharing-programme\\_en](https://ec.europa.eu/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/experience-sharing-programme_en)>, accessed 20 February 2017.

16. See, for example, Frontex, 'Two Years of Capacity Building in Eastern Partnership Countries', press release, 18 August 2016.

17. CSD, 'Study on Anti-corruption Measures in EU Border Control', p. 79.

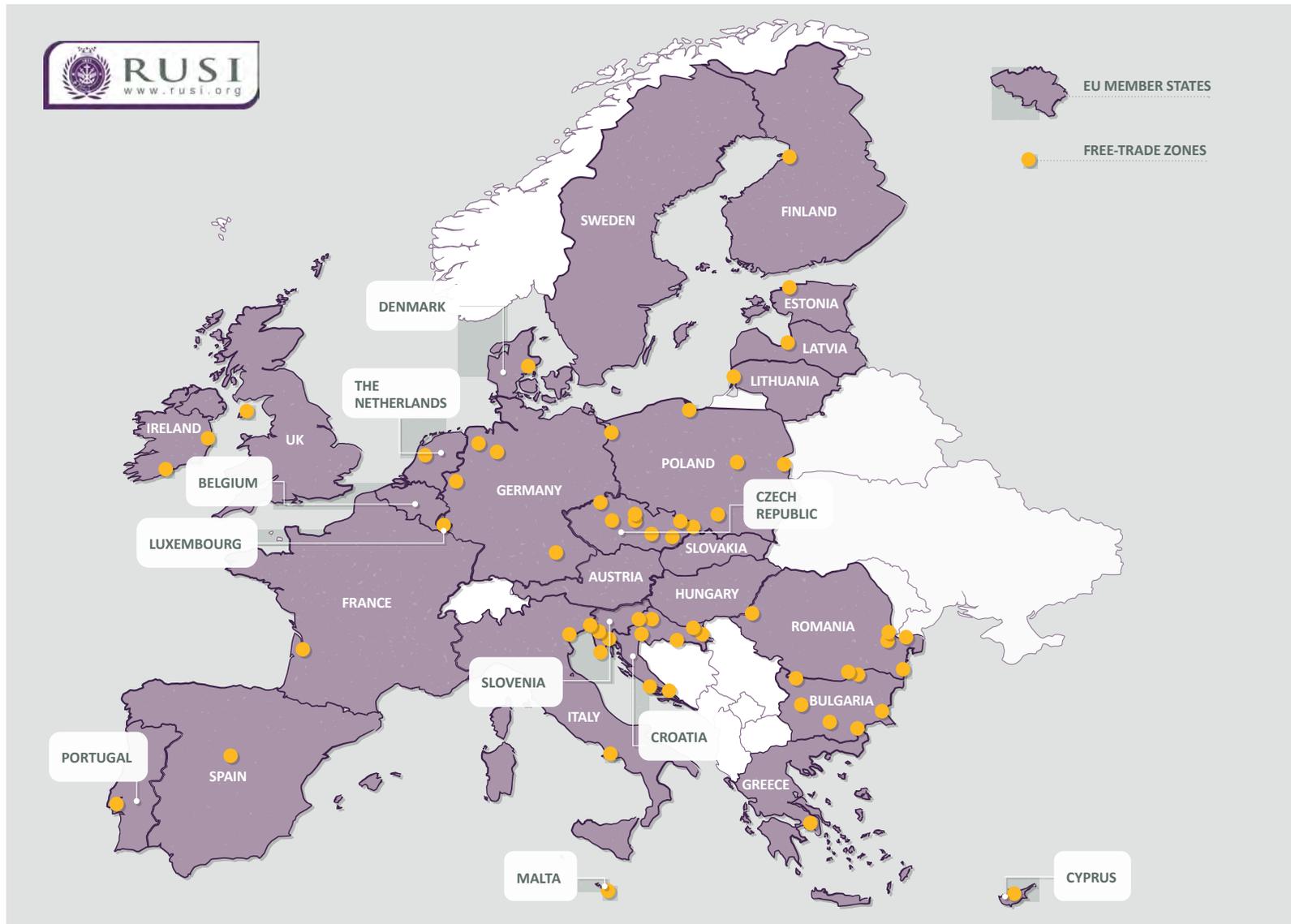
18. BASCAP, 'Controlling the Zone', p. 9.

19. Financial Action Task Force (FATF), 'Money Laundering Vulnerabilities of Free Trade Zones', March 2010, p. 8; BASCAP, 'Controlling the Zone', p. 9.

20. *Ibid.*

21. FATF, 'Money Laundering Vulnerabilities of Free Trade Zones'; Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 16.

Figure 5: Location of Free-Trade Zones in EU Member States



OCGs are exploiting these weaknesses to facilitate and conceal their activities in illicit trade. Warehousing facilities are used to conduct part of the manufacturing process, with products repackaged or relabelled.<sup>22</sup> FTZs are also used as a means to disguise the original point of manufacture, with containers transiting multiple ports or being re-documented.<sup>23</sup> This creates significant challenges for customs authorities when the goods are finally imported, as the point of origin is an important indicator in the risk-profiling that determines which containers should be subject to detailed inspection.<sup>24</sup>

**Box 8:** Case Study – Tobacco Smuggling and Free-Trade Zones

Following intelligence from the European Anti-Fraud Office (OLAF), Greek customs intercepted a container upon its arrival in Piraeus; searches revealed it to contain 9 million smuggled cigarettes.

The container had travelled from the port of Jebel Ali in the United Arab Emirates to the free-trade zone of Port Klang in Malaysia, before departing for Greece. The unpaid duties and taxes on the smuggled cigarettes totalled almost €1.6 million.

*Source: OLAF, 'Further Major Seizure of Smuggled Cigarettes in Greece Thanks to Information Gathered by OLAF', press release, 13 May 2014.*

Law enforcement and customs authorities repeatedly cited the abuse of FTZs as a concern during field research: as source or transit points outside Europe; and as entry points into the EU. The extent of the threat should not be underestimated, with officials describing some FTZs as descending towards lawless territories, such is the lack of oversight and the extent of criminal influence.

The exploitation of FTZs has been specifically linked to the illicit trade in tobacco<sup>25</sup> and pharmaceutical products.<sup>26</sup> With regard to tobacco, analysis conducted by Transcrime of illicit flows to the EU found that almost all significant origin and transit points host FTZs.<sup>27</sup> Moreover, in 2014, the World Customs Organization's (WCO) Operation *Gryphon* confirmed the practice of repackaging tobacco products within FTZs, with illicit products leaving the zones either

22. World Economic Forum Global Agenda Council on Organised Crime, 'Organised Crime Enablers', July 2012, p. 21; BASCAP, 'Controlling the Zone', p. 6.

23. *Ibid.*

24. *Ibid.*, p. 6.

25. Melzer and Martin, 'A Brief Overview of Illicit Trade in Tobacco Products', in *Illicit Trade: Converging Criminal Networks*, p. 137.

26. Lybecker, 'Illicit Trade in Counterfeit Medicines', in *Illicit Trade: Converging Criminal Networks*, p. 88.

27. Transcrime – Joint Research Centre on Transnational Crime, *European Outlook on the Illicit Trade in Tobacco Products*, p. 44.

misdeclared or concealed within other shipments.<sup>28</sup> There is similar evidence to suggest FTZs act as enablers for the illicit trade in pharmaceutical products, as illustrated in Box 9.

**Box 9: Case Study – Pharmaceutical Smuggling and Free-trade Zones**

In 2006, HMRC in the UK seized 384 kg of pharmaceutical products at Heathrow Airport. Of the eight different products detected, analysis confirmed that seven were counterfeit. The products were in transit from a company in Sharjah FTZ in Dubai to a company established in the FTZ of Freeport in the Bahamas.

Investigations uncovered a complex supply chain of illicit pharmaceutical products originating in China and travelling through Hong Kong, the United Arab Emirates, the UK and the Bahamas en route to their final destinations in Canada. Sold through an illegal online pharmacy, they were portrayed as Canadian products.

*Source: International Chamber of Commerce, Business Action to Stop Counterfeiting and Piracy (BASCAP), 'Controlling the Zone: Balancing Facilitation and Control to Combat Illicit Trade in the World's Free Trade Zones', p. 7.*

The WCO has tried to clarify the obligations of host states, defining standards for the regulation and supervision of FTZs and making recommendations for good practice; however, this is contained within Annex D, Chapter 2 of the 2006 Revised Kyoto Convention, the implementation of which is optional. Despite the significant number of signatory countries to the Convention, very few have chosen to implement these provisions.<sup>29</sup>

Other potentially valuable international agreements such as the World Trade Organization's (WTO) Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) fail to directly reference FTZs and, as such, have been interpreted by some countries as only applicable within standard customs regimes.<sup>30</sup>

While FTZs are an important part of global trade, the balance has not yet been found between facilitating trade and ensuring security. The role of FTZs in the illicit trade and consequent need for reform have been repeatedly highlighted by bodies such as FATF,<sup>31</sup> the World Economic Forum,<sup>32</sup> the

28. WCO, 'WCO Announces the Results of its First Global Operation Against Illicit Trade in Tobacco', press release, 13 October 2014, <<http://www.wcoomd.org/en/media/newsroom/2014/october/wco-announces-the-results-of-its-first-global-operation-against-illicit-trade-in-tobacco.aspx>>, accessed 20 February 2017.

29. BASCAP, 'Controlling the Zone', p. 11.

30. *Ibid.*, p. 17.

31. FATF, 'Money Laundering Vulnerabilities of Free Trade Zones', p. 8.

32. World Economic Forum Global Agenda Council on Organised Crime, 'Organised Crime Enablers', July 2012, p. 21.

International Chamber of Commerce,<sup>33</sup> the OECD,<sup>34</sup> Europol and the Office for Harmonization in the Internal Market.<sup>35</sup> A variety of recommendations have been put forward, ranging from advising states to restructure national legal frameworks, to asking the WTO to clarify the jurisdiction of TRIPS.<sup>36</sup> There would be considerable merit in such actions, but in many cases there are limited incentives for adoption. Perhaps most significantly, individual states or regions are unlikely to introduce regulations that would decrease the efficiency of their FTZ and increase the administrative burden on traders. Such measures would risk driving legitimate trade to other FTZs unaffected by the change.

Instead, clear, unambiguous global regulation is required. International action to protect the financial system against money laundering provides a valuable model. FATF is an inter-governmental body that sets global standards for legal, regulatory and operational measures for combating money laundering, with member states conducting mutual evaluations to ensure compliance. Where countries are not compliant, their designation as such adversely affects their ability to operate in the global market, providing a strong incentive.

The WCO is ideally positioned to adopt a similar role and set standards for combating illicit trade within FTZs; its comparable, near global membership could create the potential for significant impact without creating undue advantage for non-members. Without such radical, concerted and coordinated international activity, FTZs are likely to remain a key enabler for OCGs involved in the illicit trade.

## Postal and Courier Services

While the movement of goods via containers and large-goods vehicles remains widespread within areas of the illicit trade, OCGs are also making increasing use of postal and courier systems. Containers are a high-risk, high-reward strategy, moving products in bulk; in contrast, postal services are attractive because they substantially reduce both the risk of interception and potential losses. OCGs are aware that only a small percentage of parcels can be subjected to detailed scans or inspection, with authorities instead reliant on intelligence-profiling. Even if a parcel is detected, the low quantity of goods contained represents a small loss, especially when considered against the number of parcels successfully delivered in the same timeframe.

Capitalising on the growth of e-commerce, the postal system has grown increasingly popular as a method of delivery to customers.<sup>37</sup> However, there are also reports of the system being used throughout the supply chain. This is particularly relevant in the case of pharmaceutical products, where both raw active ingredients and completed products may be easily transported in relatively small parcels.

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33. BASCAP, 'Controlling the Zone'.

34. OECD and EUIPO, *Trade in Counterfeit and Pirated Goods*.

35. Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union'.

36. See, for example, BASCAP, 'Controlling the Zone', pp. 32–36.

37. OECD and EUIPO, *Trade in Counterfeit and Pirated Goods*, p. 82.

In 2012, a Polish national was arrested, suspected of being involved in the illegal shipments of viagra from China. The illicit pharmaceutical products were being imported through the post, falsely declared as coloured pencils and addressed to members of his family, including his grandmother, mother and daughter. Delivery to customers was also being made through the post. When his office was raided by the authorities, they uncovered printers producing customer address labels.<sup>38</sup>

This practice is not restricted to pharmaceuticals. Across Europe, there is evidence of the increasing use of postal and courier systems to transport illicit tobacco. From 1 April 2015 to 31 March 2016, 32 million cigarettes and more than 23 tonnes of handrolling tobacco were seized at international postal hubs in the UK alone,<sup>39</sup> while Romanian law enforcement described the delivery of 32,000 cartons of cigarettes by couriers in a single investigation. In Poland, the Ministry of the Interior has repeatedly highlighted this growing trend from 2010 onwards, linking it to increasing prevalence of online sales.<sup>40</sup> As in the case of pharmaceuticals, however, postal and courier services may also be employed earlier in the supply chain, as illustrated in Box 10.

**Box 10:** Case Study – Smuggling Tobacco Through the Post

Between July 2012 and August 2013 a group operating from the UK made 57 trips to Belgium and The Netherlands to purchase handrolling tobacco. They then transported the tobacco through the postal system, using couriers to deliver the goods to UK addresses. At least 282 parcels were delivered to members of the group in the UK, containing an estimated 4 tonnes of tobacco. An additional 1.9 tonnes were intercepted before delivery.

In 2016, fifteen people were convicted in connection with the plot, which is estimated to have cost the UK Treasury over £1 million in lost duty.

*Source: Yorkshire Post, 'Three Generations of Yorkshire Family Sentenced for Roles in £1m Tobacco Smuggling Plot', 4 December 2016.*

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38. Jeffray, 'On Tap Europe: Organised Crime and Illicit Trade in Poland, Country Report'.
39. Independent Chief Inspector of Borders and Immigration, *An Inspection of Border Force Operations at Coventry and Langley Postal Hubs: March to July 2016* (London: The Stationery Office, 2016), p. 23.
40. Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2010 roku [Report on the State of Security in Poland in 2010]', p. 165; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2011 roku [Report on the State of Security in Poland in 2011]', p. 172; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2012 roku [Report on the State of Security in Poland in 2012]', p. 186; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2013 roku [Report on the State of Security in Poland in 2013]', p. 176; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2014 roku [Report on the State of Security in Poland in 2014]', pp. 171–172.

OCGs are also adapting to circumvent intelligence-profiling in the postal system. This was outlined by Europol and the Office for Harmonization in the Internal Market in their joint 2015 report,<sup>41</sup> and was also highlighted to the author during field research. There is evidence of OCGs transporting goods into the EU through other means, often to a member state with weak controls, before breaking them down into smaller quantities and distributing them through the post.<sup>42</sup>

There are also reports of groups specifically routing production through member states with 'trusted' postal systems, so that their final products are unlikely to be scanned en route to their customers. This technique is similarly used to obfuscate the country of origin to the customer, maintaining the impression of a legitimate company operating from a country with strict regulations on consumer protection in order to increase confidence.<sup>43</sup>

Alongside national postal services, private courier companies are also at risk of exploitation. As illustrated by Operation *Dedyl* in Box 11, courier services may be exploited by OCGs to transport active ingredients across borders, and to deliver products to customers.

**Box 11: Case Study – Operation *Dedyl*, Producing and Distributing Illicit Pharmaceuticals**

In March 2015, an advert for medicinal substances was discovered on Facebook. The ensuing investigation uncovered an OCG of Bulgarian and Spanish nationals, which was distributing large quantities of anabolic steroids to amateur athletes throughout Spain.

Operating a clandestine factory in the city of Gandia, the active ingredients were principally sourced from Bulgaria, and either delivered by courier or collected by members of the OCG and transported across the border by car. Orders were made over the internet, with delivery by express courier services. Raids by the Spanish National Police also uncovered genuine products that had been diverted from legal channels, and counterfeit products from Portugal and Greece.

In total, 700 kg of illicit pharmaceutical products were seized, equivalent to 1.8 million doses. This seizure comprised 130 different products, including anabolic steroids, sexual stimulants and growth hormones. It was estimated that the group's quarterly profit from their illicit activities was more than €50,000.

*Source: Spanish National Police.*

As with national postal services, major courier companies offer delivery services without customer registration, although to use this service parcels must normally remain unsealed so that they can be subject to inspection. However, while terms and conditions include the right to inspect any parcel, there are suggestions that collections from regular, registered customers

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41. Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 30.

42. *Ibid.*

43. *Ibid.*

may proceed without such verification of the contents; without proof of customer identity and strict Know Your Customer procedures, this can create opportunities to be exploited by OCGs.

Alongside major companies, there are substantial numbers of small businesses offering courier services. Although often established to provide a legitimate service between expats and their families, they represent a substantial risk with regard to illicit trade, with small vans regularly transporting hundreds of parcels across borders, creating a significant challenge for customs. A search of local newspaper and online adverts revealed dozens of such companies operating in Poland alone. Moreover, tests of their services confirmed that parcels are normally collected without inspection or verification of customer identity; in many cases no paperwork was completed beyond noting a delivery address and contact number.

Of particular concern is the practice of cash payment on delivery, which was outlined during interviews with law enforcement officials in Poland, Greece and Romania. While this is common practice in some European countries for the delivery of legitimate goods, it creates a clear vulnerability with regard to illicit trade, denying investigators potential evidence from online payments and facilitating the anonymity of both purchaser and supplier.

National postal systems and courier services – whether major companies or sole operators – are being exploited by OCGs, and acting as unintentional enablers of illicit trade across the EU. Moreover, OCGs are adapting their practices to evade current law enforcement tactics for detection and disruption. This is relevant not only to illicit trade, but to broader organised crime activity: there are many illegal items that are sufficiently small to be transported in this manner.

## The Internet and Social Media

The increasing use of postal and courier services to deliver illicit products has been directly linked to the growth in e-commerce, with bespoke websites, auction sites and social media being used to sell illicit tobacco and pharmaceuticals.<sup>44</sup> Officials in case study countries offered limited examples of the internet being used to sell illicit alcohol, citing differences in the nature of the product making it less suitable for postal or courier delivery without detection.

The online sale of illicit goods offers numerous advantages to OCGs: first, it vastly increases their potential consumer base, removing geographic restrictions and making their products more easily accessible to new customers; second, online distribution incurs minimal running costs by comparison to physical retail; third, although more easily detectable by law enforcement, the internet offers significant anonymity, especially where domains are registered using false

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44. Lybecker, 'Illicit Trade in Counterfeit Medicines', in *Illicit Trade: Converging Criminal Networks*, p. 82; Ministerstwo Spraw Wewnętrznych i Administracji [Ministry of the Interior and Administration], 'Raport o stanie bezpieczeństwa w Polsce w 2014 roku [Report on the State of Security in Poland in 2014]', p. 172.

identities and locations obscured using proxy servers; and finally, the disruption caused by law enforcement action can be minimised, with dismantled websites quickly re-established.<sup>45</sup>

Across the EU, OCGs employ a range of methods when selling products online. Bespoke websites are often sophisticated and intended to give the appearance of legitimacy.<sup>46</sup> Experts also highlighted the practice of offering limited discount in comparison to legitimate sellers, therefore attracting customers seeking a bargain, but without arousing suspicion. This practice further broadens the potential consumer base, attracting unwitting customers who mistakenly believe they are purchasing genuine products.

**Box 12:** Case Study – Operation *Tribulus*, Online Sale of Illicit Pharmaceuticals

In 2012, a major operation to dismantle an OCG selling illicit pharmaceuticals online was undertaken by Europol, Spain’s Civil Guard (Guardia Civil) and the Agency for Medicines and Health Products (Agencia Española de Medicamentos y Productos Sanitarios), the City of London Police and the Medicines and Healthcare products Regulatory Agency (MHRA), the financial intelligence unit (FIU) in Cyprus, and the manufacturers Pfizer, Eli Lilly & Company and Sanofi-Aventis.

The OCG had been importing counterfeit erectile dysfunction products from Asia, principally China and Singapore. They were then sold online to customers throughout Europe.

Six people were arrested: two British, one Dutch, two Romanian and one Spanish citizens. Accompanying searches led to the seizure of almost 300,000 doses of illicit pharmaceutical products.

*Source: Europol, ‘Criminals Distributing Fake Viagra Busted’, press release, 19 March 2012.*

In recent years, social media has become an increasingly popular medium for the sale of illicit goods.<sup>47</sup> Experts in Spain described an emerging trend of illicit tobacco being offered for sale, while in the UK, the Medicines and Healthcare products Regulatory Agency (MHRA) has repeatedly issued warnings about the ease with which OCGs can offer pharmaceutical products for sale through mainstream service providers.<sup>48</sup>

In Romania, social media has also become host to an emerging, targeted approach for the sale of expensive medicines used to treat serious or rare diseases. Experts described sellers pretending to have lost a family member to such an illness, offering to sell their remaining medication at a discounted price so that it could ‘help somebody else’; such messages are strategically

45. Europol and the Office for Harmonization in the Internal Market, ‘2015 Situation Report on Counterfeiting in the European Union’, pp. 32–33.

46. *Ibid.*

47. *Ibid.*, p. 34.

48. Ian Sample, ‘Surge in Illegal Sales of Drugs as Gangs Exploit “Phenomenal Market” Online’, *The Guardian*, 28 December 2014; *The Telegraph*, ‘Twitter and Facebook “Allow Massive Illegal and Counterfeit Drugs Market”’, 18 June 2015.

posted in relevant support forums to reach their target audience. This represents a notable deviation from the methods used to sell lifestyle products such as medication for weight loss, erectile dysfunction or muscle gain, where the motivation for purchasing via the illicit trade is markedly different.

To combat the growing sale of illicit pharmaceutical products online, the EU Falsified Medicines Directive (FMD) has introduced a common logo which is intended to help consumers identify legitimate online retailers: from 1 July 2015, all online pharmacies in the EU were required to display the logo in accordance with the rules of their national regulator.<sup>49</sup>

The principle underlying this measure has substantial merit, but in order to be effective it must be accompanied by major public awareness campaigns as it can only protect those consumers who know to look for it.

Furthermore, while it can protect unwitting customers searching for legitimate retailers, it cannot address the growing practice of sale via social media. Here, the private companies hosting such activity must instead accept some responsibility for the content on their platforms, working with law enforcement agencies to detect and remove relevant posts. It is a further example of the encroachment of OCGs into the operations of legitimate companies, who must consequently develop defences and join the fight against organised crime: failure to do so risks passive facilitation of OCG activity.

## Social Acceptability

The function of social acceptability in enabling illicit trade was highlighted in RUSI's 2014 Whitehall Report, 'On Tap: Organised Crime and the Illicit Trade in Tobacco, Alcohol and Pharmaceuticals in the UK':

Illicit trade is widely seen as a victimless crime and the public is largely tolerant of purchasing illicit goods, even if this behaviour is seen as morally wrong ... The *acceptability* of illicit trade and the tolerance shown towards the black market economy pose serious challenges to government policy to reduce organised crime.<sup>50</sup>

In each country visited as part of the field research for this study, the purchase of illicit goods, particularly tobacco and alcohol, was similarly described as socially acceptable. It was highlighted as a key finding in Spain,<sup>51</sup> where research has shown that people are often quick to excuse involvement in illicit trade, believing it to be out of necessity and blaming limited

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49. EU, 'Commission Implementing Regulation (EU) No 699/2014 of 24 June 2014 on the Design of the Common Logo to Identify Persons Offering Medicinal Products For Sale at a Distance to the Public and the Technical, Electronic and Cryptographic Requirements for Verification of its Authenticity', *Official Journal of the European Union* (Vol. 57, L184/5), 25 June 2014.

50. Charlie Edwards and Calum Jeffray, 'On Tap: Organised Crime and the Illicit Trade in Tobacco, Alcohol and Pharmaceuticals in the UK', *Whitehall Report*, 3-14 (December 2014), p. 2.

51. Ellis, 'On Tap Europe: Organised Crime and Illicit Trade in Spain, Country Report'.

employment opportunities following the 2008 economic crisis.<sup>52</sup> In Greece, while there is a growing recognition that illicit trade and other economic crimes have contributed to the country's economic challenges, they are still largely without social stigma. Experts in Poland, Italy and Romania echoed similar messages.

Purchasing illicit tobacco or alcohol is too often seen as a minor, victimless crime, even perhaps as a small victory over the tax agency and government, which are perceived as responsible for high prices in the legitimate market. Moreover, consumers rarely recognise the link to organised crime, as highlighted by research conducted on behalf of the European Commission: when asked about the most important revenue sources for OCGs, almost 70% of respondents cited illegal drugs, but less than 15% suggested illicit tobacco.<sup>53</sup>

The illicit pharmaceutical trade presents a slightly different scenario, as the drivers for purchasing outside legal channels are not always purely financial. In the case of lifestyle drugs (for erectile dysfunction, diet or muscle gain), embarrassment about approaching a doctor or desire for a product that is unlikely to be prescribed also drives people towards illicit sources.

However, in both cases there is a clear disconnect between the increasing recognition among law enforcement agencies that illicit trade represents a significant aspect of organised crime activity, and the public perception that it is a minor, victimless crime.

This social acceptability is an important enabling factor for illicit trade across the EU, creating an environment in which demand for illicit products is tolerated. It substantially lowers the psychological barriers for entry into this form of activity, removing the social stigma that is attached to other crimes. Moreover, it increases the size of the market, with more people willing to purchase through such routes. Alongside measures to detect and disrupt the supply of illicit goods, this enabler must also be tackled to reduce demand and create a more hostile environment for OCGs looking to sell their products.

## Prosperity at the Expense of Security: EU Regulations as an Unintentional Enabler

Within the EU, regulation to facilitate cross-border trade presents a similar contradiction to FTZs: when exploited by OCGs, it undermines the legitimate economy it was created to support, diverting funds away from lawful businesses and national treasuries. The EU cannot ignore the vulnerability of such regulations to abuse, nor the role they play in enabling organised crime activity in illicit trade.

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52. ThinkCom.es, 'Estudio Sobre El Consumo de Tabaco Y Alcohol En España [Study on Tobacco and Alcohol Consumption in Spain]', October 2013, cited in Francesco Calderoni et al., *The Factbook on the Illicit Trade in Tobacco Products 7* (Trento: Transcrime and Università degli Studi di Trento, 2014), p. 86.

53. European Commission, 'Special Eurobarometer 443: Public Perception of Illicit Tobacco Trade', July 2016, p. 17.

## Duty Evasion

Bonded warehouses share a number of similarities with FTZs; however, the scope of illicit trade facilitated is much smaller, and the opportunities for intervention by customs authorities far greater.

European rules on excise holding and movement allow payment of duty on goods to be ‘suspended’ while they circulate between registered bonded warehouses in the EU. They are designed to benefit traders who import goods, offering a facility that delays duty and/or import VAT payments until traders are ready for the goods to come out of ‘duty suspense’, entering free circulation or the customs procedure of another EU member state.

OCGs take advantage of vulnerabilities in the bonded warehouse system to manipulate stock records or create duplicate loads, enabling goods to enter the market with no VAT having been paid in the relevant member state (Box 13).

### **Box 13:** Case Study – Operation *Gorpros Blanco*, Bonded Warehouse

In May 2016, the Spanish Civil Guard and Tax Agency announced the disruption of a criminal group that they claimed had defrauded the Public Treasury of more than €3.7 million.

The group’s system had been to purchase alcohol products in another EU country – usually The Netherlands and Portugal – and store them in bonded warehouses, before selling them to distributors and retailers in Spain without payment of the required VAT.

Ten people have so far been arrested, with charges including offences against the Public Treasury and belonging to a criminal organisation.

*Source: Spanish Civil Guard, ‘La Agencia Tributaria y la Guardia Civil Desarticulan un Entramado en el Sector de las Bebidas Alcohólicas Orientado a la Defraudación del IVA [The Tax Agency and the Civil Guard Undermine Alcoholic Drinks VAT Fraud Network]’, 2 May 2016.*

Missing trader intra-community fraud is a more complex form of duty evasion. An example would be an illicit trader selling goods to another illicit trader, who in turn sells it on, and so forth. The first trader defaults on the VAT payments that are due to the relevant national tax authority. The subsequent traders then falsely reclaim the VAT on goods, which they continually import and export to and from other EU states. As the goods are sent round and round across numerous EU borders, the activity has also become known as ‘carousel fraud’ (Box 14).

Since it is only relevant to the smuggling of genuine products, the scope of illicit trade unintentionally facilitated by mechanisms designed to support intra-community trade is therefore narrower by comparison to that conducted through FTZs. However, it still represents substantial losses to EU member states through unpaid excise duty and VAT. OCGs use these

techniques to smuggle both alcohol and tobacco, which are subject to relatively high tax payments in many member states.

**Box 14:** Case Study – Operation *Cocktail*, Alcohol Carousel Fraud

In November 2014, joint action by eight member states, supported by Eurojust and Europol, targeted multiple OCGs that had been involved in a sophisticated carousel fraud scheme.

The groups were employing similar modus operandi, using falsified export accompanying documents to create a complex supply chain across EU member states, including duplicated and phantom transactions. Their intention was to conceal the destination of the alcohol being traded, avoiding the payment of VAT, while fraudulently reclaiming it at subsequent stages of the carousel.

Nineteen members of the OCGs were arrested, following the execution of European arrest warrants in Germany, Romania and the UK, as well as national arrest warrants in Italy. In total, 31 premises were searched, leading to the seizure of financial assets, weapons, computers, vehicles, mobile phones and documents.

*Source: Eurojust, 'Operation Cocktail: Successful Action Against Alcohol Carousel Fraud', press release, 13 November 2014.*

Mirroring the abuse of FTZs, EU regulations intended to facilitate legitimate trade are exploited by OCGs to conduct illicit trade, becoming unintentional enablers. However, unlike the current regimes governing FTZs, there is no ambiguity regarding the jurisdiction of national customs authorities. Moreover, steps are being taken across the EU to facilitate the detection and investigation of customs fraud.

In September 2016, legislation came into force enabling customs authorities to access new databases that record the physical movement of maritime trade, gathering information on the goods entering, transiting and leaving the EU.<sup>54</sup>

Moreover, in April 2016 the European Commission adopted an Action Plan on VAT, which includes measures intended to frustrate duty evasion in cross-border trade:

The present system, which has been in place since 1993 and was supposed to be transitional, splits every cross-border transaction into an exempted cross-border supply and a taxable cross-border acquisition. It is like a customs system, but lacks equivalent controls and is therefore the root of cross-border fraud. ... A robust single European VAT area would treat cross-border transactions in the same way as

54. EU, 'Regulation (EU) 2015/1525 of the European Parliament and of the Council of 9 September 2015, Amending Council Regulation (EC) No. 515/97', *Official Journal of the European Union* (Vol. 58, L 243/1), 18 September 2015; see European Anti-Fraud Office (OLAF), 'EU Customs Investigators Get New, Powerful Tools to Combat Fraud', press release, 1 September 2016.

domestic transactions, putting an end to the endemic weakness of the system, and would integrate the management and enforcement of VAT through closer cooperation between tax administrations.<sup>55</sup>

Under the single European VAT area, exemptions for intra-community sales would be abolished, with the tax due at every relevant sale in the supply chain. This would mirror the VAT rules for supply chains within national boundaries. With regard to both bonded warehouses and carousel fraud, it is the cross-border VAT exemptions and duty suspensions that create opportunities for exploitation by OCGs, and both of these would be removed. Referencing research undertaken by EY on behalf of the European Commission,<sup>56</sup> the plan claims that such changes ‘should reduce cross-border fraud by about EUR 40 billion (80%) a year in the EU’.<sup>57</sup>

The European Parliament voted on 24 November 2016 to back these proposals,<sup>58</sup> and the Commission is now preparing a legislative proposal to introduce this definitive VAT system for cross-border trade.

### Parallel Trade

The term ‘parallel trade’ refers to the practice in the EU of trading products that are bought cheaply in one part of Europe and sold in another part at higher prices. It is legal within the pharmaceutical market, but the system is vulnerable to abuse as products are allowed to be repackaged so that instructions and health warnings appear in the correct language. This accepted practice of breaching manufacturer seals therefore creates an opportunity for criminals to infiltrate the legitimate supply chain by, for example, inserting illicit products into the discarded genuine packaging rather than destroying it (Box 15). Reprinting labels also creates the possibility of expiry dates being forged, enabling the illegal sale of expired products.<sup>59</sup>

Protection against such infiltration is challenging due to the difficulties in monitoring the supply chain for pharmaceutical products once they enter the parallel market: it has been estimated that they are subjected to an average of 20–30 intermediary transactions,<sup>60</sup> with no obligation for anyone within the process to record batch identification numbers.<sup>61</sup>

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55. European Commission, ‘Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on an Action Plan on VAT: Towards a Single EU VAT Area – Time to Decide’, COM(2016) 148 final, 7 April 2016, p. 9.

56. European Commission and EY, *Implementing the ‘Destination Principle’ to Intra-EU B2B Supplies of Goods – Feasibility and Economic Evaluation Study: Final Report* (Brussels: European Commission, 2015).

57. European Commission, ‘Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on an Action Plan on VAT’, p. 10.

58. European Parliament, ‘Towards a Definitive VAT System and Fighting VAT Fraud’, (2016/2033(INI)), Provisional Text P8\_TA-PROV(2016)0453, 24 November 2016.

59. UNICRI, ‘Counterfeit Medicines and Organised Crime’, p. 22.

60. *Ibid.*, p. 25.

61. Lybecker, ‘Illicit Trade in Counterfeit Medicines’, in *Illicit Trade: Converging Criminal Networks*, p. 88.

**Box 15: Case Study – Operation *Volcano*, Infiltration of the Parallel Pharmaceuticals Market**

On 31 March 2014, a German distributor raised concerns about a defective vial of the cancer treatment Herceptin that had been received from a wholesaler in the UK through the parallel import system. Investigation by the German federal institute for vaccines and biomedicines, the Paul-Ehrlich-Institut, confirmed these concerns, highlighting that the batch number of the primary and secondary packaging differed, some products appeared to have been opened, and the powder product had partially liquidised.

The Italian pharmaceutical agency (Agenzia Italiana del Farmaco, AIFA) linked the vial to a theft from a delivery truck in Italy. Such thefts, from hospitals, pharmacies and delivery vehicles, had become increasingly common in Italy from 2012 onwards, prompting investigations by AIFA and the establishment of a database to record and track batch information from each incident.

The subsequent investigation uncovered further adulterated vials in Germany, Finland and the UK along with unauthorised operators in Cyprus, Hungary, Latvia, Romania, Slovakia and Slovenia who were facilitating the illicit supply chain through issuing fake invoices. Those invoices created a 'legitimate' origin for the stolen products, which were transferred to an Italian licensed wholesaler. From this point the stolen vials were part of the 'legitimate' supply chain.

*Source: AIFA, 'Operation Volcano, The Herceptin Case: Story, Lesson Learned, Proposals', September 2015.*

The EU Falsified Medicines Directive (FMD) aims to increase protection of the legitimate supply chain by introducing obligatory authentication features on packaging and strengthening record-keeping requirements for distributors, among other measures.<sup>62</sup> These specific provisions are detailed in a Delegated Act that will come into force in February 2019.<sup>63</sup>

The measures expressly encompass the parallel market:<sup>64</sup> while parallel traders will still be able to re-package products so that instructions and health warnings appear in the correct language, they will do so under increased regulation. They will also be required to verify the integrity

62. Council of the European Union, 'Directive 2011/62/EU of the European Parliament and Council of 8 June 2011, Amending Directive 2001/83/EC on the Community Code Relating to Medicinal Products for Human Use, as Regards the Prevention of the Entry into the Legal Supply Chain of Falsified Medicinal Products', *Official Journal of the European Union* (Vol. 64, L 174/74, 1 July 2011).

63. Council of the European Union, 'Commission Delegated Regulation (EU) 2016/161 of 2 October 2015, Supplementing Directive 2001/83/EC of the European Parliament and of the Council by Laying Down rules for the Safety Features Appearing on the Packaging of Medicinal Products for Human Use' *Official Journal of the European Union* (L 32/1, 9 February 2016).

64. It is clear that the FMD is not intended to prevent parallel trade. Indeed, the Delegated Act specifically references concerns about differing national authentication mechanisms limiting circulation of pharmaceutical products within the EU, citing it as a justification for introducing these common requirements. The clear implication is that while it may impose additional requirements on parallel traders, as across the whole pharmaceutical industry, in the longer term it is intended to facilitate rather than restrict the practice – albeit within the confines of a more tightly controlled supply chain.

of the package received, and upload information onto a central repository system to create an audit trail.

If implemented and enforced stringently across the EU, such measures might therefore reduce exploitation of the parallel trade and restrict attempts by OCGs to infiltrate the legitimate supply chain of pharmaceutical products.

# III. Evaluating the Response

**W**HILE THE TRUE scale of illicit trade in the EU cannot be accurately quantified, there is no doubt that it is extensive and wide-ranging, denying EU governments vast sums and bringing potentially dangerous products into member states. Dominated by OCGs, illicit trade is enabled by corruption, the lack of control in FTZs, the ease with which products can be purchased online and delivered through the post, and the willingness of many EU citizens to use criminal markets.

If the EU is to see a substantial and enduring reduction in illicit trade, its response must be comprehensive, incorporating regulatory, investigative and prosecutorial measures. However, the limited ratification of both EU and international measures are limiting their impact. Moreover, while law enforcement agencies are increasingly focused on the OCGs driving illicit trade, questions remain about intelligence sharing and cooperation.

It is also evident that current sanctions are ineffective in deterring both new entrants to illicit trade and repeat offenders. Instead, their relative leniency within member states influences decisions by OCGs about where to conduct operations or which routes to take when transporting goods.

## Investigation and Prosecution

### Law Enforcement Agencies

There is growing recognition within law enforcement agencies that illicit trade represents an important part of organised crime activity. Responsibility for tackling it is often assigned to specialist organised, economic or intellectual property crime units, with some states outlining their response to the threat within national strategies.<sup>1</sup>

However, while this is a positive development in the EU, it obscures some inconsistencies within member states. Firstly, not all countries have such strategies. Secondly, while individual officers and departments may recognise the role of OCGs behind illicit trade, there were suggestions that investigative techniques, such as surveillance or controlled deliveries, were not always

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1. See, for example, in the UK, HMRC and Border Force, 'Tackling Illicit Tobacco: From Leaf to Light: The HMRC and Border Force Strategy to Tackle Tobacco Smuggling', March 2015; and HMRC, 'The HMRC Alcohol Strategy: Modernising Alcohol Taxes to Tackle Fraud and Reduce Burdens on Alcohol Businesses', March 2016; in Poland, Służba Celna [Customs Service], 'Strategia Działania Służby Celnej W Zakresie Zwalczania Przemytu I Nielegalnego Obrotu WYROBAMI TYTONIOWYMI NA LATA 2012-2015 [Strategy of Customs Service to Combat Trafficking and Illicit Tobacco Products, 2012-2015]', 22 March 2012; in Spain, Agencia Española de Medicamentos y Productos Sanitarios [Spanish Agency of Medicines and Medical Devices], 'Estrategia Frente a Medicamentos Falsificados 2016-2019 [Strategy Against Falsified Medicines 2016-2019]', 11 April 2016.

used. Too often, seizing goods at the border was considered the successful conclusion of an operation. While the immediate harm to consumers and the economy may have been prevented, opportunities to develop intelligence on the underlying network are missed. In some cases, this has hampered the strategic understanding of the threat picture.

During the research for this report, concerns were also raised regarding the relative prioritisation of different products within illicit trade. It was suggested that authorities were more proactive in their investigation of illicit tobacco than other goods. However, as noted above, the data regarding illicit tobacco, both in terms of volume and detail, greatly exceed those for either illicit alcohol or pharmaceuticals. The information in Chapter I outlining the fluctuations in the illicit cigarette market across time, within member states and across the EU, cannot currently be replicated for other products.

It is therefore difficult to assess the comparative scale of the threat from different illicit goods. This creates challenges for law enforcement in terms of effectively prioritising resources, and also for those seeking to objectively evaluate such priorities. Without comparable data for products such as illicit alcohol, it is difficult to assess the merit of concerns that it receives insufficient focus in some states.

At the regional level, Europol and EUIPO have recently established a centre dedicated to the fight against organised crime and the illicit trade. The Intellectual Property Crime Coordinated Centre (IPC3) aims to provide technical support to member states, and lists as its objectives: facilitating and coordinating cross-border investigations; monitoring and reporting emerging modus operandi in illicit trade; enhancing the harmonisation of legal instruments and operating procedures; and offering training on this specific field of expertise.<sup>2</sup>

Similarly, the European Anti-Fraud Office (OLAF) works with national customs authorities to conduct joint customs operations in relation to illicit markets that have an impact on the EU budget, such as tobacco and alcohol. In this role, OLAF coordinates efforts across multiple member states, offering analytical, administrative and financial support. Through the Hercule III programme,<sup>3</sup> OLAF also finances practical projects in member states such as the purchase of scanning equipment, and funds training activities, such as workshops and conferences to share best practice. There are also measures in place to limit resource duplication across these different EU agencies: for example, OLAF joint customs operations always include a liaison officer from Europol.

These initiatives bring substantial value in monitoring emerging trends, providing training and, crucially, facilitating cross-border investigations. However, this coordination needs to be mirrored at the national level. Ironically, investigations within national boundaries often lack

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2. Europol, 'Launch of the IPC3: Europe's Response to Intellectual Property Crime', press release, 12 July 2016, <<https://www.europol.europa.eu/newsroom/news/launch-of-ipc3-europe%E2%80%99s-response-to-intellectual-property-crime>>, accessed 21 February 2017.
  3. OLAF, 'About the Hercule Programmes', <[https://ec.europa.eu/anti-fraud/policy/hercule\\_en](https://ec.europa.eu/anti-fraud/policy/hercule_en)>, accessed 28 February 2017.

comparable inter-agency cooperation, with intelligence shared only at the latter stages of an investigation. This was a consistent criticism during field research. Even where mechanisms have been established to de-conflict investigations, they remain unavoidably reliant on agencies proactively sharing intelligence. National experts claimed that, too often, inter-agency rivalry and a protective nature towards investigations limited cooperation, which is fundamental to tackling a threat which spans the responsibility of police, customs and border agencies.

Cooperation with the private sector presents a similarly mixed picture across member states. In some cases it was cited as a notable strength, with investigations resulting directly from industry intelligence. In other examples, cooperation was positive but more restricted, with private companies principally providing assistance in assessing the authenticity of seized products, or in gathering data on the overall scale of the illicit trade rather than cooperating at an operational level.

Wherever they are adversely affected by illicit trade, industries have considerable incentive to assist law enforcement agencies in tackling it. They have skills and expertise that may not be available in the public sector, as well as considerable resources, which, during a time of relative austerity across Europe, may be used to provide valuable indirect support.

For example, initiatives to gather data on the scale and scope of the threat may be resourced by industry, requiring no intelligence sharing from law enforcement agencies, but offering a potentially valuable source of information. Similarly, industry intelligence, such as assessments of legal sales, can provide early indications of activity in the illicit market; in Spain, an unexplained 30% drop in sales in the province of Jaén led directly to the discovery of a company selling illicit tobacco online, and the seizure of enough bulk tobacco to produce 4 million packs of cigarettes.<sup>4</sup> Public–private partnerships can therefore be a valuable asset in the fight against modern organised crime, provided that they are transparent and carefully managed.

## **National Regulators**

As OCGs seek to infiltrate legal supply chains, the regulators that control relevant industries become crucial in the fight against illicit trade.

The role of regulators was found to vary substantially across member states. For example, in the UK the MHRA is responsible for regulating the sale of medicines and has both intelligence and enforcement functions in relation to the illicit trade. In contrast, in Poland the General Pharmaceutical Inspectorate (Główny Inspektorat Farmaceutyczny, or GIF) has very limited powers beyond regulating practices in the legal market. Other agencies fall between these extremes, with Italy's pharmaceutical agency (Agenzia Italiana del Farmaco, AIFA) working closely with the Carabinieri – the national gendarmerie – in investigations, but possessing no individual enforcement powers.

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4. Agenzia Tributaria [Tax Agency], '41 Tonnes of Tobacco Seized in a Large Police Operation Against the Illegal Manufacture and Sale of Smoking Tobacco', press release, 27 November 2015.

There was no consensus during fieldwork about the merit of regulators adopting law enforcement functions, or about the most effective regulatory model. Indeed, given the considerable variations across member states with regard to legislative frameworks and law enforcement competencies, it would be impossible to establish a single template.

However, it is clear that the basic role of regulators in monitoring and controlling the legal market is growing in importance. As outlined above, there is evidence of OCGs registering for wholesale or retail licences in order to infiltrate legal supply chains. Information gathered during fieldwork indicated considerable and concerning variations in the investigation conducted before granting such licences, creating vulnerabilities to be exploited.

In Poland, there was a substantial increase in the number of pharmaceutical wholesaler companies registering with GIF, with no comparative growth in the market to justify such an increase. OCGs are suspected to be at least partly responsible, flooding GIF with registrations and operating with legitimate licences until such time as it can sort through the backlog of cases to identify any illegitimate businesses.

In this environment, stringent due diligence within regulated sectors is a crucial aspect of the defence against illicit trade, and the value of proactive regulators should not be overlooked.

### **Prosecution**

The successful prosecution of OCGs is also vital if the disruption of their activities and their networks is to be substantial and enduring. The value of prosecutors who understand illicit trade within the context of organised crime was repeatedly highlighted during field research. Cases can be complex, crossing multiple jurisdictions and requiring specialist understanding of this crime area and related legislation; subject matter experts can be as valuable here as during investigations.

Most national experts expressed frustration at the current situation. While there has been growing recognition within law enforcement agencies that illicit trade is an important part of organised crime, this has not been mirrored among prosecutors or in the judiciary. As a result, few have developed the specialist knowledge required. Indeed, it was notable that many national experts proposed awareness-raising and training programmes as a means to redress this perceived weakness in the fight against illicit trade.

The role and potential impact of prosecutors is of even greater importance in jurisdictions where investigations are prosecutor-led, and agencies can pursue an investigation only if so instructed. They also play a key role in connecting and coordinating the prosecution of different cases – for example, when arrests are made in different parts of the country yet the individuals are part of the same organised crime network. It was suggested by law enforcement agencies that without dedicated specialists to guide them, regional prosecutors can see only part of the picture when OCGs operate at the national (or indeed international) level, hampering effective intelligence collection and investigation.

The introduction of specialised prosecutors could have a positive impact on efforts to tackle illicit trade. Where individual prosecutors have developed a detailed understanding of this area of organised crime, law enforcement agencies described stark differences in terms of their value and impact: first, in outlining the case within the context of organised crime activity; second, in ensuring comprehensive charges are brought;<sup>5</sup> and third, in calling for more substantial sentences. Moreover, the Italian experience in establishing dedicated anti-mafia prosecutors (Direzione Nazionale Antimafia, or DNA) offers a clear example of the potential value of specialised prosecutors in areas of complex crime.

### **European Public Prosecutor's Office**

The European Commission has also proposed measures which would increase the expertise and coordination of prosecutors across member states. In July 2013 it proposed that a European Public Prosecutor's Office (EPPO) be established to investigate and prosecute offences relating to the financial interests of the EU. Its remit would therefore mirror that of OLAF, and in relation to illicit trade, encompass products that are subject to taxation, such as tobacco and alcohol.

Under the current system, OLAF and Eurojust support cross-border activities by member state authorities, but neither has the legal competence to directly conduct prosecutions. While OLAF may conduct administrative investigations, ultimately the decision to initiate criminal proceedings rests with the member states, and in 2013 it was found that only 20% of such cases resulted in a conviction, with rates varying considerably across the EU.<sup>6</sup>

The EPPO is intended to address this inconsistency. Delegated Prosecutors would be embedded in the judiciary of each member state, conducting investigations under national legislation, but supervised and coordinated by a centralised European Public Prosecutor. The EPPO would therefore directly facilitate cross-border investigations and prosecutions, and increase consistency in the treatment of relevant crimes across the EU. It would also create, in effect, a community of expert prosecutors in this area.

At the time of writing, significant progress has been made towards the establishment of the EPPO, with provisional agreement in the European Council on a number of articles in the proposed regulation. However, discussions are ongoing, and it is not yet clear when the EPPO might be established. While it is a potentially valuable institution in the fight against illicit trade, this uncertainty, together with a remit restricted to illicit trade directly affecting the EU budget, means that establishing specialised prosecutors within member states should remain an independent objective.

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5. For example, in some states legislation permits supplementary charges for acting as part of an OCG. This issue was also raised by Europol and the Office for Harmonization in the Internal Market in: Europol and the Office for Harmonization in the Internal Market, '2015 Situation Report on Counterfeiting in the European Union', p. 38.

6. European Commission, 'Every Euro Counts – Frequently Asked Questions on the European Public Prosecutor's Office', MEMO/13/693, 17 July 2013.

## Legislation, Regulations and Sanctions

Relevant legislation and regulation vary considerably across member states, and while the accompanying country reports from this study consider the approach taken in each of our case studies, it is beyond the scope of this report to assess and compare each system across the EU.

It is, however, an area in which both EU and international bodies have been active in seeking to ensure national systems adequately address the threat from illicit trade. Despite considerable merit in some of the measures proposed, their limited ratification by national governments severely limits their impact. Moreover, they also have inherent limitations, addressing only aspects of the threat.

### The Tobacco Products Directive

Within the EU, the Tobacco Products Directive entered into force on 19 May 2014,<sup>7</sup> and became applicable across member states on 20 May 2016. With regard to illicit trade, perhaps the most significant measure is the introduction of an EU-wide track-and-trace system, intended to secure the legal supply chains of tobacco products. It will require all tobacco products to include visible and invisible security features, entering into force from 2019 for cigarettes and handrolling tobacco, and in 2024 for other products. Assuming an effective system is introduced, it can therefore offer a valuable means of preventing diversion of genuine products into illegal channels.<sup>8</sup> It would also help to protect the legal supply chain from infiltration by counterfeit goods.

However, it will not prevent the sale of counterfeit goods through illegal distribution chains. Nor is it likely to have a considerable impact in relation to illicit whites, which are largely produced legally in non-EU countries, then imported into member states and sold outside legal channels. As noted above, illicit whites have been a rapidly growing problem and in 2015 were estimated to have accounted for over one-third of illicit cigarettes in Europe.<sup>9</sup> While track-and-trace systems are therefore a potentially important measure, this is a substantial limitation that must be acknowledged.

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7. Council of the European Union, 'Directive 2014/40/EU of the European Parliament and of the Council of 3 April 2014 on the Approximation of the Laws, Regulations and Administrative Provisions of the Member States Concerning the Manufacture, Presentation and Sale of Tobacco and Related Products and Repealing Directive 2001/37/EC', *Official Journal of the European Union* (L 127/1, 29 April 2014).

8. Melzer and Martin, 'A Brief Overview of Illicit Trade in Tobacco Products', in *Illicit Trade: Converging Criminal Networks*, p. 139.

9. KPMG, 'Project Sun: 2015 Results', p. 7.

## WHO Framework Convention on Tobacco Control and Protocol to Eliminate Illicit Trade in Tobacco Products

The WHO Framework Convention on Tobacco Control (FCTC) entered into force on 27 February 2005.<sup>10</sup> It is a wide-ranging global public health treaty, and Article 15 specifically addresses the illicit tobacco trade.<sup>11</sup>

The FCTC was followed in 2012 by the Protocol to Eliminate Illicit Trade in Tobacco Products (hereafter, the Protocol),<sup>12</sup> which builds on the commitments expressed in Article 15. While it was accorded formal confirmation by the EU in June 2016, it has not yet been ratified by a sufficient number of the other signatories to enter into force.

It has been described by Interpol as ‘the most comprehensive attempt by the international community to condense into one dedicated legal instrument all the measures necessary to eliminate the ITTP [illicit trade in tobacco products] by means of a criminal justice approach’.<sup>13</sup> Indeed, it contains a number of valuable measures.

First, it seeks to ensure adequate supply chain control through the provisions in Part III. Participating states are required to implement a licensing system for the manufacture, import or export of tobacco products,<sup>14</sup> and to endeavour to introduce licensing for the broader supply chain, including growing, transporting, wholesale and retail functions.<sup>15</sup> As part of this system, there is a requirement for due diligence to be undertaken, sales to be monitored and evidence of illicit activity reported.<sup>16</sup>

Part III also includes a requirement for the introduction of track-and-trace technology. Forming part of an international treaty, this system is potentially broader than that under the EU Tobacco Products Directive. However, it is notable that some of the principal sources of illicit whites in the EU market – such as Belarus and the United Arab Emirates, home to the Jebel Ali Free Zone – are not signatories.<sup>17</sup> Therefore, although it is an important measure for securing legal supply chains, it is likely to face the same restrictions as the EU-wide system with regard to addressing broader illicit trade.

It should also be noted that ‘key inputs’ to the manufacture of tobacco products are beyond the scope of the Protocol. Cigarette papers, cellulose acetate tow and other essential components of tobacco products would therefore not fall under the regulatory systems it seeks to create.

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10. FCTC, ‘The WHO Framework Convention on Tobacco Control: An Overview’, January 2015.

11. *Ibid.*, p. 3.

12. FCTC, *Protocol to Eliminate Illicit Trade in Tobacco Products* (Geneva: World Health Organization, 2013).

13. Interpol Office of Legal Affairs, ‘Countering Illicit Trade in Tobacco Products: A Guide for Policy-makers’, *Legal Handbook Series*, June 2014, p. 47.

14. FCTC, *Protocol to Eliminate Illicit Trade in Tobacco Products*, Article 6, Section 1.

15. *Ibid.*, Section 2.

16. *Ibid.*, Article 7.

17. KPMG, ‘Project Sun: 2015 Results’, p. 16.

Due to the highly specialised nature of such products, control appears possible without undue impact on other industries: cigarette papers are specifically designed to control factors such as density, porosity and burn rate, therefore having extremely limited broader application;<sup>18</sup> similarly, cellulose acetate tow is principally manufactured for cigarette production, with more than 80% of world produce being used within this industry.<sup>19</sup> Strict control over the supply of such ingredients would be an asset in the fight against illicit tobacco, including counterfeit products and illicit whites, which are not adequately addressed through track-and-trace systems;<sup>20</sup> their omission from the proposed supply chain control should therefore be viewed as a missed opportunity and a limitation of the Protocol in its current form.

Interestingly, the Protocol also requires participating states to establish ‘effective controls on all manufacturing of, and transactions in, tobacco and tobacco products, in free zones’,<sup>21</sup> but it provides limited detail or guidance, and a number of countries with major free-trade zones are absent from the Protocol’s signatories. The impact of this provision is therefore likely to be limited.

Second, Part IV of the Protocol imposes an obligation to ensure that activities in the illicit tobacco trade are proscribed under national law,<sup>22</sup> and subject to ‘effective, proportionate and dissuasive criminal or non-criminal sanctions, including monetary sanctions’.<sup>23</sup> It further provides that where special investigative techniques, such as controlled delivery, undercover operations and surveillance are available in domestic law, they are made available for investigations relating to illicit tobacco trade.<sup>24</sup>

Finally, Part V includes provisions relating to information sharing and cooperation between the parties. It imposes obligations to share information, where appropriate, in relation to seizure data, trends, concealment methods and smuggling modus operandi.<sup>25</sup> It also requires states to ensure there are measures in place to enable cooperation between law enforcement agencies during investigations and prosecutions.<sup>26</sup>

While the Protocol is therefore a comprehensive criminal justice response to the illicit tobacco trade, it remains unlikely to enter into force in the short term: at the time of writing, it requires ratification by a further sixteen parties. The scale and complexity of the provisions should also not be underestimated, potentially requiring considerable legal, administrative and technical reform by participating states.<sup>27</sup> Moreover, it is missing some key signatories, which may limit its impact, in particular with regard to illicit whites.

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18. Interpol Office of Legal Affairs, ‘Countering Illicit Trade in Tobacco Products’, p. 66.

19. *Ibid.* p. 67.

20. Interpol Office of Legal Affairs, ‘Countering Illicit Trade in Tobacco Products’, pp. 65–69.

21. FCTC, *Protocol to Eliminate Illicit Trade in Tobacco Products*, Article 12, Section 1.

22. *Ibid.*, Article 14.

23. *Ibid.*, Article 16, Section 1.

24. *Ibid.*, Article 19.

25. *Ibid.*, Article 20.

26. *Ibid.*, Articles 21, 24, 27 and 29.

27. Interpol Office of Legal Affairs, ‘Countering Illicit Trade in Tobacco Products’, p. 55.

## Medicrime Convention

Similar concerns may be expressed in relation to the Council of Europe's Medicrime Convention (henceforth, the Convention).<sup>28</sup> Recognised as the first major international treaty to make the production and distribution of illicit pharmaceutical products a criminal offence,<sup>29</sup> it was opened for signature in late 2011, entering into force on 1 January 2016 following ratification by five nations.<sup>30</sup>

The Medicrime Convention shares many similarities with the Protocol, requiring participating states to ensure that activities in the illicit pharmaceutical trade are proscribed until national law. This includes the manufacture of 'counterfeit medical products, active substances, excipients, parts, materials and accessories', and is therefore comprehensive in its scope, addressing both completed products and their constituent parts.<sup>31</sup> It also covers activities relating to the supply of products,<sup>32</sup> and the falsification of documents,<sup>33</sup> while specifying that acting as part of a criminal organisation should be treated as an aggravating factor.<sup>34</sup>

The Convention also seeks to ensure that such offences are treated as serious crime by national agencies, specifying that states must 'ensure effective criminal investigation and prosecution of offences established in accordance with this [Convention], allowing, where appropriate, for the possibility for its competent authorities of carrying out financial investigations, of covert operations, controlled delivery and other special investigative techniques'.<sup>35</sup> Further provisions address interagency cooperation and information exchange,<sup>36</sup> including an option for the Treaty to be considered 'as the legal basis for extradition or mutual legal assistance in criminal matters'.<sup>37</sup>

While not a panacea, the Convention does therefore contain a number of valuable measures in the fight against the illicit pharmaceutical trade. However, at the time of writing, it has only been ratified by eight members of the Council of Europe and one non-member. Notably, it has not been ratified by the EU, or by many member states; of our case study countries, only Spain has brought the Convention into force with domestic legislation. Until more widely adopted, its impact will therefore remain severely limited.

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28. Council of Europe, 'Council of Europe Convention on the Counterfeiting of Medical Products and Similar Crimes Involving Threats to Public Health', CETS 211, 28 October 2011.

29. Lybecker, 'Illicit Trade in Counterfeit Medicines', in *Illicit Trade: Converging Criminal Networks*, p. 100.

30. Including at least three member states of the Council of Europe.

31. Council of Europe, 'Council of Europe Convention on the Counterfeiting of Medical Products and Similar Crimes Involving Threats to Public Health', Article 5.

32. *Ibid.*, Article 6.

33. *Ibid.*, Article 7.

34. *Ibid.*, Article 13.

35. *Ibid.*, Article 16, Section 2.

36. *Ibid.*, Article 17, Section 1.

37. *Ibid.*, Article 21, Section 3.

## Sanctions

Widespread activity in illicit trade is clear evidence that OCGs perceive the potential benefits to substantially outweigh the risks. A key component of this calculation is the likely penalty upon conviction, which could include imprisonment and the confiscation of criminal assets. The latter could play an important role in deterring involvement in illicit trade. Illicit trade is driven by profit, so the threat of financial losses is potentially powerful. Moreover, the confiscation of assets can disrupt activities, preventing the purchase of ingredients, machinery or replacement stock.

However, asset recovery is a complex and often challenging area, requiring expert financial investigation and the ability to freeze assets pending prosecution to prevent them being dispersed and concealed. Alongside the necessary legal framework, law enforcement agencies therefore need adequate resources and specialist training. Moreover, financial investigation must be viewed and undertaken as an integral part of the broader investigation, not an avenue to explore upon conviction, as without prompt action, there are unlikely to be discoverable assets to recover. However, it is not clear that the value of this approach has been recognised and adopted across the EU, with responses varying between member states.

As the key findings in the Poland,<sup>38</sup> Spain,<sup>39</sup> and Romania<sup>40</sup> country reports suggest, national experts are concerned about the application of lenient sanctions, even where national legislation provides for potentially strong penalties. Low sanctions have been specifically identified as ‘an incentive for OCGs to enter this low risk, high profit crime area’,<sup>41</sup> and it is notable that both the Medicrime Convention and the Protocol to Eliminate Illicit Trade in Tobacco Products specify that offences should be subject to ‘effective, proportionate and dissuasive’ penalties,<sup>42</sup> clearly underlining their important role as a deterrent.

At present, not only do sanctions fail to deter new participants, they similarly fail to prevent reoffending, and the same individuals and OCGs are often seen returning to the illicit trade following prosecution. Moreover, upon resuming their illegal activities, they do so with greater knowledge of law enforcement methods and capabilities, adapting in response and therefore becoming an increasingly difficult target for subsequent investigations.

There are also growing indications that the likely sanctions within member states influence decisions by OCGs regarding where to conduct operations or which routes to take when

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38. Jeffray, ‘On Tap Europe: Organised Crime and Illicit Trade in Poland, Country Report’.

39. Ellis, ‘On Tap Europe: Organised Crime and Illicit Trade in Spain, Country Report’, *RUSI Occasional Papers* (January 2017).

40. ‘On Tap Europe: Organised Crime and Illicit Trade in Romania, Country Report’.

41. Europol and the Office for Harmonization in the Internal Market, ‘2015 Situation Report on Counterfeiting in the European Union’, p. 39. The same argument is also made, specifically in relation to illicit tobacco, by Melzer and Martin, ‘A Brief Overview of Illicit Trade in Tobacco Products’, in *Illicit Trade: Converging Criminal Networks*, p. 124.

42. This language appears in Council of Europe, ‘Council of Europe Convention on the Counterfeiting of Medical Products and Similar Crimes Involving Threats to Public Health’, Article 12; and FCTC, *Protocol to Eliminate Illicit Trade in Tobacco Products*, Article 16, Section 1.

transporting goods across the EU. Increased consistency in the penalties for illicit trade is therefore an important objective, as encapsulated by OLAF Policy Director Margarete Hofmann:

We need to ensure that criminals are ... brought to justice, and that they are sanctioned according to the gravity of their acts, irrespective of where they may commit them. This means that we cannot afford to allow criminals the luxury of forum or sanction shopping across Europe.<sup>43</sup>

This is not a new concern, and within Europe attempts are underway in response. First submitted by the Commission in July 2012, the Protection of the Union's Financial Interests Directive includes provisions to address this objective;<sup>44</sup> however, the draft text is the subject of disagreements within the Council and at the time of writing remains on hold.

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43. Margarete Hofmann, speaking at a RUSI conference in Brussels on 22 November 2016.

44. European Parliament, 'European Parliament Legislative Resolution of 16 April 2014 on the Proposal for a Directive of the European Parliament and of the Council on the Fight Against Fraud to the Union's Financial Interests by Means Of Criminal Law (COM(2012)0363 – C7-0192/2012 – 2012/0193(COD)) (Ordinary Legislative Procedure: First Reading)', 16 April 2014.



# Conclusion: On Tap Across the EU

**A**N OFFICIAL QUIETLY stamping paperwork; a lorry passing across internal EU borders; an innocuous parcel in a postman's van: this is what organised crime looks like in Europe. It is, of course, only one side of a multifaceted threat, but while the more violent elements of organised crime demand our attention, illicit trade is quietly capitalising: infiltrating our economies, bringing dangerous goods into our communities and diverting billions of euros away from EU governments.

The illicit trade is the epitome of modern organised crime in its reflection of legitimate business: groups are quick to recognise and respond to opportunities; they diversify their activities to minimise risk and maximise investment; they capitalise on new technologies; they build a network of contacts with varied expertise; and they cooperate with international partners.

Across Europe, this is not the organised crime threat that law enforcement was designed to tackle. Law enforcement is used to fighting strict hierarchical groups, but organised crime groups (OCGs) no longer have this structure; they are becoming 'loose, undefined and flexible networks'.<sup>1</sup>

However, the most recognised definition of an OCG remains that enshrined in the UN Convention against Transnational Organised Crime, which, in 2000, defined an OCG as a 'group of three or more persons, existing for a period of time and acting in concert with the aim of committing one or more serious crimes ... in order to obtain ... financial or ... material benefit'.<sup>2</sup> As highlighted by Europol in 2015, '[t]his definition continues to reflect law enforcement authorities' conceptualisation of organised crime ... but does not adequately describe the complex and flexible nature of modern organised crime networks'.<sup>3</sup> While OCGs have evolved, law enforcement has adhered to structures and approaches that were designed to tackle a different threat.

But while law enforcement needs to evolve, there are also new allies to support them in their task. International bodies, industry regulators and affected sectors all have a role to play in reducing organised crime; as technology, infrastructure and regulation have advanced to facilitate legitimate business and cross-border trade, OCGs have found ways to similarly utilise these mechanisms, making them unintentional enablers of the illicit market. Efficient global commerce is an integral part of modern life, but the balance has not yet been found between facilitating trade and ensuring security.

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1. Europol, *Exploring Tomorrow's Organised Crime* (The Hague: European Police Office, 2015), p. 12.
  2. United Nations Office on Drugs and Crime, 'United Nations Convention Against Transnational Organized Crime and the Protocols Thereto', adopted by General Assembly resolution 55/25 of 15 November 2000.
  3. Europol, *Exploring Tomorrow's Organised Crime*, p. 11.

The approach to prosecution and sanction across the EU also requires reform. At present, member states are ineffective in deterring both new entrants to illicit trade and repeat offenders. Fundamentally, the rewards are too high and the risks are too low. Until this balance can be altered illicit trade will remain a key aspect of organised crime activity and continue to be a threat across the EU.

Alongside such measures, we must also face an uncomfortable truth: corruption at EU borders is a critical enabler of the illicit trade. Corrupt officials can undermine otherwise strict controls and enable the EU's outer defences to be easily breached by OCGs seeking to import counterfeit or unlicensed goods. At present, there is no comprehensive, coordinated programme to assess the scope, scale and impact of corruption at the EU border; nor is there guidance for member states on detection, investigation or prevention. This needs to change.

Across the EU there are thousands of dedicated law enforcement professionals; however, until comprehensive and concerted action is undertaken, the corrupt minority will continue to undermine their work and – potentially – all other measures intended to prevent, detect or disrupt the activity of OCGs in the illicit trade.

## Recommendations

### European and International Institutions

1. **International standards must be established for free-trade zones to prevent their descent towards lawless territories that enable organised crime.** FTZs are being exploited by OCGs, who take advantage of their limited oversight to re-document shipments and conceal their true origin, or even to conduct parts of the manufacturing process. There are no enforceable international standards governing FTZs, officials described some FTZs as descending towards lawless territories. While FTZs are an important part of global trade, the balance has not yet been found between facilitating trade and ensuring security.  
States are unlikely to act alone as national measures would undoubtedly reduce efficiency, potentially driving legitimate business to competing FTZs. Instead, clear, unambiguous global regulation is required. The World Customs Organization is ideally placed – but currently too weak – to impose international change and should be reformed, following the model provided by FATF in regulating the international financial system.
2. **Europol and the European Border and Coast Guard Agency (Frontex) should establish a dedicated centre to support member states in tackling corruption within the public sector.** Corruption at European borders is a critical enabler of illicit trade. Corrupt officials can undermine otherwise strict controls and enable the EU's outer defences to be easily breached by OCGs importing counterfeit or unlicensed goods. While some corrupt officials are prosecuted, there are reports of many more cases where corrupt officials were quietly transferred or dismissed and concerns that yet more remain undetected. The volume of illicit goods reaching EU markets would also seem to suggest that corruption is still a serious problem.

Europol and Frontex should jointly establish a dedicated anti-corruption centre to provide expert guidance in establishing vetting procedures, offer training for the detection of corruption among officials, and support member state investigations.

3. **Europol and OLAF should establish a joint review of intelligence-profiling in postal systems, given the tactics used by OCGs to obfuscate the origins of parcels.** OCGs are making increasing use of postal and courier systems, sending lower volumes of goods with greater frequency. Unable to scan the vast quantities of post entering the country, member states have instead employed intelligence-profiling to target parcels from locations considered high risk. However, OCGs are adapting to this strategy, transporting goods into the EU through other means before distributing them through the post, or specifically routing production through states with ‘trusted’ postal systems. In light of this evolving approach, strategies for detection at postal hubs need to be reviewed.
4. **The EU should review the regulation of private courier services.** As OCGs increasingly send goods in smaller shipments, and often directly to online customers, private couriers are at risk of exploitation – just like national postal services. While new customers may see their parcels inspected by a courier, there are suggestions that returning customers may be more trusted, creating opportunities for OCGs to exploit.

In addition to major companies, there are reports of substantial numbers of small businesses offering courier services across member states, often established to provide a legitimate service between expats and their families. However, these services run a substantial risk of being used for illicit trade, with small vans regularly transporting hundreds of parcels across borders after collecting only minimal details from senders. There is also a broader security concern here, as many illegal items – not just tobacco, alcohol and pharmaceuticals – may be transported in this manner. Requirements for company registration, KYC procedures and parcel inspection should be reviewed and strengthened.

5. **Sanctions for illicit trade must be reviewed and revised to increase consistency across member states.** Current sanctions for illicit trade do not act as an effective deterrent – they fail to deter both new entrants and repeat offenders. There is also increasing evidence that the sanctions within member states influence decisions by OCGs about where to conduct operations or which routes to take when transporting goods across the EU. Increased strength and increased consistency in the penalties for activity in the illicit trade should therefore be an important objective.

First submitted by the Commission in July 2012, the Protection of the Union’s Financial Interests Directive includes provisions to directly address this objective; however, the draft text is the subject of disagreements within the Council and, at the time of writing, remains on hold.

6. **Measures must be adopted to protect consumers unwittingly involved in the illicit trade.** The internet is a primary enabler for the sale of illicit goods across Europe, particularly pharmaceutical products. While many consumers intentionally purchase goods illicitly, others are deceived into believing they are making a genuine purchase, with OCGs creating increasingly professional websites. OCGs are also adapting their methods for different audiences: lifestyle products are sold relatively openly on forums and social

media, but there are also reports of OCGs targeting those with serious illnesses, posing as bereaved parties who want their loved one's remaining medicine to be of use.

Alongside work to reduce the demand for illicit products, steps must also be taken to protect those who purchase illicit products unwittingly. The introduction of the common EU logo for online pharmacies is a promising step; however, in order to be effective it must be accompanied by major public awareness campaigns – it can only protect those consumers who know to look for it.

## EU Member States

7. **Law enforcement agencies must develop internal strategies to combat illicit trade; they cannot focus solely on the border for detection and disruption.** There is growing evidence of illicit goods being manufactured within the EU in order to reduce both transport costs and the risks associated with transiting the EU's external border. While the border will always represent a key intervention point, intelligence-gathering and disruption strategies must also encompass domestic activity, including goods being sent through the post.

8. **Law enforcement agencies should form temporary national task forces to tackle OCGs, following the format of international joint investigation teams (JITs).** Across the EU there is evidence of OCGs becoming active in multiple crime types. Flexible network structures produce agile groups who are quick to recognise and respond to market conditions, moving between crime and product types as opportunities arise. In contrast, law enforcement agencies often work in silos, with separate departments or agencies focusing on specific crime types.

National agencies tackling organised crime should mirror the flexible networked approach of their targets, following the format of international JITs. Investigators should be considered subject matter experts, able to join together as temporary task forces to identify the most efficient and effective way to disrupt an OCG. To facilitate this approach, they should be supported by a team of analysts, sifting intelligence to identify where investigations overlap. Such an approach would retain critical specialist knowledge, while ensuring efficient use of resources through early identification of overlapping investigations. Moreover, where appropriate, this approach could encompass experts from multiple agencies, such as police and customs.

9. **There is a need for a new model of public–private partnership across the EU to facilitate information sharing.** OCGs are increasingly establishing, infiltrating and simulating 'legal' businesses to obscure their illegal activities. The appearance of legitimacy can facilitate importing or exporting illicit goods across national borders and, in the case of shell companies, can also hinder attempts by law enforcement to identify the individuals profiting from the activities.

Member states must ensure that there are mechanisms in place to allow industry regulators and members of the private sector to share data and suspicions with law enforcement agencies to reduce vulnerabilities through early detection. Section 7 of the UK's Crime and Courts Act 2013 offers an example of a successful non-coercive mechanism, permitting information sharing without imposing any undue obligations.

10. **National regulators must have a stronger role in combating crime in their sector, with clearly defined responsibility for performing due diligence in relation to both new and existing companies.** OCGs are also penetrating the specific sectors in which they are trading, registering for wholesale or retail licences in order to infiltrate legal supply chains. Regulated sectors at risk of infiltration by OCGs must ensure that stringent due diligence is applied to both new and existing companies. While in some cases this may require reform, if enacted, such reform has the potential to increase protection of legitimate supply chains and frustrate the activities of OCGs.
11. **Member states should establish dedicated prosecutors who specialise in organised crime and illicit trade.** In the fight against illicit trade, the successful prosecution of OCGs is crucial if the disruption of their activities and networks is to be substantial and enduring. The value of prosecutors who understand illicit trade within the context of organised crime was repeatedly highlighted during field research. Subject matter experts can be as valuable here as during investigations. The Italian experience in establishing dedicated anti-mafia prosecutors (Direzione Nazionale Antimafia, or DNA) offers an example of the potential impact of specialised prosecutors in areas of complex crime.
12. **Asset recovery and financial penalties must be used to strengthen deterrence.** Fundamentally, illicit trade is attractive to OCGs because the financial rewards are vast and the associated risks are low. Strong, effective asset recovery regimes would help to alter this balance. Member states must ensure that law enforcement agencies have the authority, skills and resources to conduct financial investigations, and to freeze and ultimately recover criminal assets.

## Research

13. **There is a need to improve the data on which assessments of the scale and scope of illicit trade are made; wherever possible, comparable methodologies must be adopted to enable analysis across time, place, products and criminal methods; this is vital to inform the effective prioritisation of law enforcement resources.** Limitations in the methodologies available to estimate the scale of illicit trade must not become a barrier to their application. For example, while empty-pack surveys may not capture each element of the illicit tobacco market, they still offer a valuable indication of scale and scope; their use by law enforcement agencies alongside seizure data is testament to the potential value of even imperfect methodologies.<sup>4</sup>

Innovation in relation to other criminal products and methods should be similarly explored and supported, for example: measuring the chemicals in sewage and contrasting the result with the levels expected based on legal prescriptions;<sup>5</sup> or combining measures capturing difficult elements of the market, such as alcohol tax-gap estimates<sup>6</sup>

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4. During fieldwork conducted by the author, law enforcement agencies repeatedly referenced KPMG's 'Project Sun', which uses empty-pack surveys as part of its methodology.

5. See Bastiaan J Venhuis et al., 'Success of Rogue Online Pharmacies: Sewage Study of Sildenafil in The Netherlands', *British Medical Journal*, 2 July 2014, p. 349.

6. See HMRC, 'Statistics and Methodological Annexes Relating to Measuring Tax Gaps', 20 October 2016.

and unexplained imports of industrial alcohol.<sup>7</sup> Given the evident value to industry in reducing the illicit trade, major companies should consider funding such endeavours.

14. **The demand for illicit goods must be tackled alongside the supply.** Social acceptability is a key enabler of the illicit trade across the EU, creating an environment in which demand for illicit products is tolerated. Research should be undertaken to understand what would be the most effective means of reducing the social acceptability, and therefore the demand, for illicit goods. There is a pressing need to understand what messages are effective, from what sources, through what medium and under which circumstances.

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7. See Jeffray, 'On Tap Europe: Organised Crime and Illicit Trade in Poland, Country Report', pp. 14–15.

# About the Author

**Clare Ellis** is a Research Fellow in the National Security and Resilience Studies group at RUSI, where she leads the institute's work in relation to organised crime and illicit trade. A member of the National Police Chiefs' Council's Illicit Trade group, her research has examined the threat in the UK and across Europe. Clare is also Chair of RUSI's Strategic Hub for Organised Crime Research, which was established in partnership with the Home Office, the National Crime Agency, the Foreign and Commonwealth Office, and Research Council UK's Partnership for Conflict, Crime and Security. Beyond organised crime, her research interests also include counterterrorism, where her work has focused on the threat from lone attackers.

Clare has undertaken research on behalf of the European Commission and the British and Danish governments, conducting fieldwork in the UK, Europe and West Africa. A regular speaker at international conferences, she is also a guest lecturer at the University of York. Prior to joining the RUSI she worked in the criminal justice sector, first in criminal defence and later in the police. Clare holds an MSc with Distinction in Countering Organised Crime and Terrorism from University College London, where her dissertation examined the spatial and temporal distribution of terrorism incidents within post-accord Northern Ireland. She has also studied at the University of Newcastle and the Université Lumière Lyon 2, holding a Bachelor's degree in Law with French.