The fog of sanctions:

Global banks and businesses face unprecedented challenges in applying measures against Russia

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Contents

Executive summary

In the months since Russia's invasion of Ukraine, the tidal wave of Western sanctions, export controls, and prohibitions against providing certain corporate services in Russia has largely been digested by many global financial institutions. Some have chosen to expend considerable resources on getting to know their customers better so they can keep doing business with unsanctioned parties in Russia; while others have opted to "de-risk" and avoid the country entirely, exiting account relationships and disentangling themselves from funds transfers tied to Russia.

Varying expectations among nations and a widespread dearth of guidance are making compliance with the unprecedented complexity of Russia sanctions difficult and costly. Besides Russia, Belarus and Russian-occupied areas of Ukraine have been targeted for sanctions. Legal, regulatory, and reputational risks have rocketed.

For its part, Russia continues to describe its actions in Ukraine as a "special operation" and seems so far to be weathering the sanctions, in part due to an increase in crude oil exports to India and China.

Meanwhile, the United States and its allies are investigating sanctions evasion activity with an eye toward criminal prosecutions. US bank regulators have publicly stated that their examiners will be looking into compliance with the sanctions, and the US Treasury Department continues to churn out guidance aimed at helping financial institutions avoid compliance pitfalls. Further, the European Union and the United Kingdom have issued broad sanctions and prohibitions on corporate services, while drawing criticisms that they have failed to provide clarity regarding regulatory expectations.

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While the pace of new sanctions has slowed considerably in recently weeks, many sanctions and anti-money laundering compliance officers continue to work long hours and to spend unprecedented amounts of time with senior officers and legal counsel as they struggle to meet all of the new operational demands imposed on them since Russia launched its invasion on February 24.

This makes the current moment an unprecedented time for the international finance and trade sectors, and many financial services firms are finding it difficult to hire financial crime compliance professionals to help meet added demands.

Still, Western sanctions targeting Russia will for the foreseeable future continue to grab headlines and create headaches for financial institutions and their compliance officers. And many officials believe Western enforcement authorities will seek to make examples of any parties caught aiding sanctions evasion.

Further, regulators are also watching how companies disclose the impact of the war in Ukraine and Western sanctions on their financial performance. For example, the US Securities and Exchange Commission in May notified companies that it would be monitoring how they disclose such impacts and wrote to Citigroup that it needed to enhance its disclosures.

In this new white paper, the Thomson Reuters Regulatory Intelligence team examines the evolving sanctions environment in several countries, including the United States, the United Kingdom, and their European allies. In addition to examining what each country is doing by itself and in concert with others, this paper also looks at the troubling lack of clarity and cooperation among allies in properly applying sanctions against Russia on a global basis that would arguably have the most impact.

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Further, the paper looks at how many countries, and especially the US, are addressing gaps in their anti-money laundering and countering the financing of terrorism (AML/CFT) efforts that have been exposed by the sanctions.

Finally, the paper delves into the secondary — but no less critical — challenges with which governments and global banks are dealing because of the Russian sanctions. These challenges, beyond the application and execution of the sanctions themselves, include everything from the rise of so-called reputation launderers that are working with Russian oligarchs to help them evade the sanctions or obscure their assets; the problem of asset flight as more global players (both Russian and not) move their assets out of the oversight of regulatory agencies or sanction officers; and finally, to the state of financial services firms' compliance teams as they find themselves lacking the resources and the talent to fully address the burdens that the new sanctions regime has place upon them.

Indeed, compliance professionals short of desperately needed funding may wish to share this reality (and this paper) with their boards as they push for additional resources.

Section 1: The lack of clarity on Russia sanctions among the US, EU & UK stymies banks

Western sanctions against Russia following its invasion of Ukraine are some of the most complex economic punishments ever meted out by the United States, EU, UK and other nations. While the US Treasury Department has been pushing out reams of guidance, its allies have offered little clarity, leaving an information vacuum and major compliance challenges, officials said.

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For US banks, "most of the pain is more on the EU side than the US side," said a veteran sanctions compliance officer at one of the largest US banks. "The US is pretty clear in comparison and has well-established precedents, whereas Europe is lacking that, and we continually see conflicts between EU Commission guidance, which isn't binding, and what national-level authorities actually say on topics like aggregation of ownership by sanctions targets or trading in Russian securities," the source said.

This lack of EU sanctions compliance guidance is not new, but it has been exacerbated by the complexity of the Russia sanctions. The EU took some steps in July to deal with the problem of the uneven implementation of its sanctions policy across the 27 EU member states when the Commission wrote to national enforcement agencies. It proposed the creation of an EU-wide sanctions authority to coordinate responses by each member state to new regulations and licenses. As things stand, the Commission determines the names of sanctioned entities, but each member state is left to handle its own implementation.

The US legislative push

In the US, the war in Ukraine has also added to the push to impose anti-money laundering (AML) obligations on financial "gatekeepers" such as lawyers and accountants. The US House of Representatives in July included a bill targeting gatekeepers in the FY2023 National Defense Authorization Act (NDAA). However, this bill has become very fluid, and it is unclear whether specific professions will be named in the final draft. Still, the move increases the likelihood, previously considered slim, that the Establishing New Authorities for Business Laundering & Enabling Risks to Security Act (ENABLERS Act) will be enacted by Congress. The NDAA is a national defense bill that historically is passed by Congress each year.

It appears the defense bill has become an effective new vehicle for members of Congress to enact AML legislation. Russia's aggression in Ukraine and the perceived role of gatekeepers in sanctions evasion and laundering of corrupt funds have added to the perception that AML legislation is a national security priority and thus belongs in the defense bill. (Lawyers in Europe and the UK have had AML obligations for more than a decade because of the European Union's Third Money Laundering Directive of 2005.)

The sanctions push is far from over, however. In late June, leaders of the Group of Seven major nations made commitments to further punish Russia, exploring a ban on transporting Russian oil that has been sold above a certain price to try to deplete Moscow's war chest.

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The "primary sanctions" Washington have used to punish Moscow to date require compliance from US persons, while secondary sanctions bar companies regardless of location from doing business with people and entities Washington has blacklisted, officials said. Such a move, previously made by Washington to punish North Korea and Iran, would force firms to choose between doing business with Russia and doing business with the United States or in US dollars, a step that would dramatically complicate sanctions compliance. The only reason the US government has not unleashed these powers against Russia to date is concern about entangling Western allies that are still purchasing Russian oil and gas.

US President Joe Biden has asked Congress for new powers to seize the assets of Russian oligarchs, and other Western allies have also acted against Russian wealth. Broad and precedent-setting litigation can be expected in the coming months and years regarding assets already seized. Financial institutions may find themselves drawn into these proceedings in situations such as when seized assets had been used as collateral.

US sanctions authorities are generally recognized to be more alert to the needs of sanctions enforcement across the regulated sector. Peter Piatetsky, who runs consultancy Castellum.AI, a global risk database covering sanctions, export controls, and other risk categories, wrote that the US Office of Foreign Assets Control (OFAC) "has over 1,000 [frequently asked questions] and clearly organized guidance, and the EU has *this* document." Piatetsky was referring to a 1,700-word web page on the Commission site entitled "*Restrictive Measures Explained*".

Since Russia's invasion of Ukraine, OFAC has issued more than 100 new FAQ documents — including those defining terms such as "new investment" and "person located in the Russian Federation" — and processed hundreds of requests for licenses and interpretive guidance.

Despite this torrent of guidance, and in some cases because of it, negotiating US sanctions against Russia remains akin to walking a tightrope for bank compliance units, officials said. "Things remain complicated as the FAQs and general licenses bring their own level of complicated and broad verbiage, which at times needs to be reviewed by our counsel, bringing additional time [burden] and costs to the bank," said Daniel Gutierrez, a Miami-based bank compliance officer and chair of the Financial & International Business Association (FIBA) AML compliance committee.

Inconsistency in sanctions policy hampers effectiveness

Sanctions policy lacks consistency, agreed Katya Hazard, associate managing director with financial crimes advisory firm K2 Integrity. "The Russia program is one of the most complex sanctions programs ever implemented, because there is no comprehensive ban on dealings with Russia, its government, and its residents, but instead a fragmented approach to target some sectors of the Russian economy, but spare others. Many financial institutions state that their life would have been easier had this been a comprehensive sanctions regime," she said.

> ***The Russia program is one of the most complex sanctions programs ever implemented.***

For example, the United States in May barred US persons from providing accounting, trust, and corporate formation, as well as management consulting services to people and entities in Russia. The EU and UK issued similar prohibitions but have not yet published "any further determination or guidance on what it means," Hazard said.

In contrast, in June, OFAC updated a series of FAQs related to such professional services "and they contain numerous definitions and examples of what is permissible and what is not", she added. "The scope of the EU prohibition is slightly different and, for example, includes provision of public relations services that are not targeted by the United States. Any global bank with [a] presence in the United States, EU, and UK will have difficulty implementing these prohibitions because of their different scope and multiple rounds of guidance," Hazard said. "This is just one example of a lack of uniformity among various authorities."

Other jurisdictions such as Australia, Canada and Japan have also imposed sanctions on Russia. "It is hard to document these prohibitions and to develop sets of procedures that are effective and relatively easy to implement," she noted. "Some banks choose to interdict all activity or funds transfers involving Russia and conduct in-depth analysis of whether they are permissible, putting an enormous strain on their compliance and legal departments."

Still, inconsistencies remain

More troubling, significant inconsistencies exist between the lists of sanctioned individuals adopted by the main sanctioning offices. For example, the UK added Vladimir Potanin, one of Russia's natural resources oligarchs (as well as the owner of Rosbank) to its sanctions list on June 29, but this name does not appear on the US sanctioned lists thus far. Australia and Canada have also sanctioned him.

Potanin is the largest shareholder in MMC Norilsk Nickel, a major contributor to Russia's gross domestic product. The measure freezes his personal assets. The London Metal Exchange was examining the consequences of the UK's move for the market, and merger plans between Norisk Nickel and Oleg Deripaska's Rusal may also be thwarted, it was reported.

The US authorities have also left the name of Dimitry Mazepin, the head of Uralchem, a fertilizers and chemicals operation, off their sanctions list, although the UK and EU sanctioned him in May 2022.

Also, Russian gold exports were sanctioned by UK authorities at the end of June, while exports from Belarus, a Russian ally, were added to the UK sanctions list on July 4.

Section 2: Addressing AML/CFT gaps exposed by the sanctions

The US Treasury Department recently outlined measures to increase transparency in the US financial system and strengthen its framework against money laundering and terrorism financing. The strategy document directly reflects the impact of Russia's war in Ukraine and subsequent sanctions imposed against Moscow.

The 38-page National Strategy for Combating Terrorist and Other Illicit Financing emphasizes a need to crack down on the use of shell companies and other means of disguising asset ownership and to support compliance efforts by financial institutions. The document, published in May, recognized that "those seeking to undermine global security and stability are exploiting" gaps in the US AML framework.

"Illicit finance is a major national security threat and nowhere is that more apparent than in Russia's war against Ukraine, supported by decades of corruption by Russian elites," said Elizabeth Rosenberg, assistant secretary for terrorist financing and financial crimes at the US Treasury.

The strategy outlines the need to close regulatory gaps in the US AML/CFT framework. It recommends three actions: *i*) assessing opportunities to update reporting requirements and thresholds; *ii*) enhancing risk-focused supervision; and *iii*) appropriately resourcing AML/CFT supervision for certain non-bank financial institutions.

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> ***- Elizabeth Rosenberg, US Treasury***

Action from the NY Department of Financial Services

The New York Department of Financial Services had already outlined new compliance and risk management obligations arising from the crisis in Ukraine. The guidance, issued in February, addressed compliance issues related to sanctions, cybersecurity, and virtual currencies; and it serves as a valuable reminder and resource for firms across the United States.

It was accompanied by an executive order from New York Gov. Kathy Hochul that directed all New York State agencies and authorities to review and divest public funds from Russia following its invasion of Ukraine. The governor also acted to strengthen the enforcement of sanctions against Russia, including the expedited procurement of blockchain analytics technology.

The hope is that such a move will boost the Department of Financial Services' ability to detect the exposure of virtual currency businesses to sanctioned Russian banks, entities, and individuals.

Scrutiny of hedge funds

The invasion has raised scrutiny of private fund managers such as hedge and private equity funds as well. With some Russian oligarchs known to be prominent investors in such funds, and some oligarchs subject to sanctions for their ties to Russian President Vladimir Putin, the need to know who is investing in a fund and what it means for compliance are challenges virtually all private funds face.

The answers to the sanctions challenge may be clear-cut for many fund managers, but less so in instances where the ultimate beneficial ownership of an investor is unclear or purposefully obscured. Fines for dealing with sanctioned entities have historically been quite steep, but this time around, public perception and possible reputational damage stemming from an inadvertent violation could be worse than an actual violation itself. And regardless of whether investors are not sanctioned or might have distant ties to sanctioned entities, private fund managers must proceed with extreme caution and conduct a thorough review of their investors.

The heightened scrutiny surrounding potential Russian exposure raises additional challenges such as privacy and public disclosure to other investors who are inquiring about Russian exposure. Another challenge is whether a fund manager should freeze or forcibly redeem an investor's accounts even though the individual has not been officially added to the sanctions list. How to go about freezing such an account is another complicated task.

> ***Sanctions violations can have serious consequences and are enforced on a strict liability basis, in which there is no requirement that the violation be shown to be intentional. Erring on the side of caution is crucial.***

Under OFAC rules, firms are obligated to ensure that none of their investors are more than 50% owned directly or indirectly by persons or entities on the sanctions list. Looking through myriad shell companies and complex ownership structures often associated with such individuals can be difficult. Fund managers may therefore decide to opt for a lower threshold than 50%. In some cases, subscription documents and AML/know-your-customer (KYC) checks may contain representations made by the investors. Such representations should be re-verified.

Many fund subscription agreements allow for the manager to terminate — essentially kick out — any investor at any time for any reason. If a manager decides to err on the side of caution and remove an investor from the fund, they often have the contractual right to do so. Yet, removing a suspected entity or individual should be done carefully and may be problematic. The last thing a manager would want to do is return funds in violation of sanctions against an investor or their bank. Freezing of the assets is therefore likely to be the best course.

Whether the assets should be segregated or left invested with management fees continuing to be assessed, and how the ultimate return of the assets are handled, are all difficult questions. Each instance will need to be decided on a case-by-case basis, after careful consultation with counsel.

Sanctions violations can have serious consequences and are enforced on a *strict liability basis*, in which there is no requirement that the violation be shown to be intentional. Erring on the side of caution is crucial, with a threshold set well below the mandated 50%, as the reputational damage to all concerned could be far greater than a sanctions violation penalty.

Pressure on financial institutions

European financial institutions are experiencing a shortage of specialist sanctions staff, said Saskia Rietbroek, executive director of the Association of Certified Sanctions Specialists International in Maastricht, Holland.

US firms have staffed up much more quickly than their European counterparts, Rietbroek said, adding that unlike European firms, the larger US financial institutions have hundreds of people working in sanctions. Not surprisingly, pressure on those European banks which have correspondent relationships with Russian banks has been intense.

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"Financial institutions might have a large number of payments which are expected to be processed in real time and stopping that process to check manually in real time, with insufficient staff, poses resourcing challenges," she said.

Banks setting up foreign exchange accounts for Russian clients may be at risk of scrutiny by a correspondent bank, should it become concerned that the clients could be sanctioned. For example, United Arab Emirates-based Commercial Bank International restricts Russian clients from opening accounts based in the local currency, the Emirati dirham, said David Pije, the bank's chief compliance officer in Dubai.

"De-risking" increasingly seen as a practical solution

As complex and varying expectations among nations and a widespread dearth of guidance make compliance with Russia sanctions costly and heighten regulatory and reputation risks, banks are increasingly "de-risking" the country. They are exiting most or all clients there and ending involvement in funds transfers, officials said.

Not only are there thousands of new sanctions, but there are also hundreds of new guidance documents, said Castellum.AI's Piatetsky. "So, a lot of the sanctions can't just be resolved at level one or level two, they have to go to level three or general counsel. Yes, something is sanctioned, but there's a license for it, but the license is only active for 30 days and only applies to X product, etc."

In cases where business is still allowed with Russia, doing the business is so complicated and requires so much compliance review that it is not profitable except on enormous accounts, he added. "So, there is both a sanctioning of Russia, but also a de-risking that is going on by those who can, because it's so hard to make any money."

> ***The scale and scope of the recent Russia prohibitions result in one of the most difficult sanctions programs the private sector has been required to implement.***

Yet, even de-risking can be challenging, Hazard, of K2 Integrity, observed. "To the extent a bank decides to implement an outright ban on Russia-related activity, it may face pressure from the clients that may continue to have exposure to Russia or are in the process of winding down their operations there," she said. "These clients oppose any blanket ban on Russia funds transfers, and if the client is an important corporate client, the bank will need to conduct a thorough analysis to ensure legality of any requested funds transfers."

Many of the compliance challenges are not new, Hazard added, but "the scale and scope of the recent Russia prohibitions result in one of the most difficult sanctions programs the private sector has been required to implement."

Section 3: More challenges — "reputation launderers", asset flight and a lack of compliance resources

To make matters more difficult, *reputation launderers* are hindering sanctions and financial crime compliance teams' ability to conduct enhanced due diligence and make accurate judgements about the risks that certain customers pose.

The services such professionals provide can permit kleptocrats, oligarchs, and politically exposed persons (PEPs) to layer their wealth into Western economies where it is difficult for compliance staff and law enforcement to detect and, ultimately, to disentangle any illicit transactions.

> ***Reputation laundering is a growing industry involving lawyers, accountants, public relations firms, and image consultants, who guide and advise kleptocratic actors and PEPs through a process of rebranding, transforming them from despot to debutante.***

This process can involve such tactics as: giving large sums to charities, universities, and political parties; buying citizenship through golden visa schemes; inviting politicians onto their company boards; and placing flattering articles about themselves in showcase publications.

"It is this rebranding of an unsavory past that is the essence of reputation laundering," wrote Tena Prelec, a research fellow at the Department of Politics and International Relations at the University of Oxford, earlier this year. "By minimizing and obscuring evidence of corruption and authoritarianism in their home country, reputation laundering enables kleptocrats to enjoy their spoils freely around the world.

"It also allows authoritarian governments to manipulate public perception, sometimes even by undermining the functioning elected representatives in national and international institutions," Prelec added.

Such manipulation distorts these actors' sanctions and financial-crime risk profiles. Once reputation launderers have transformed their clients' social and business image, it is difficult for compliance professionals to differentiate between legitimate and illegitimate activity, or to effectively screen for negative news.

While London has come under fire as a haven for kleptocrats, academic research and the International Consortium of Investigative Journalists' Pandora Papers show that such enabling activity is common. The United States, France, and Portugal are among the countries leading the offerings of reputational laundering services.

Disabling enablers

Governments have been slow to address the enabler problem, and enforcement bodies lack the staffing and resources to enforce the rules that do exist. Further, lawmakers have been reluctant to clamp down on kleptocrats' enablers despite increasing concerns about the influence these individuals and their enablers wield in the spread of disinformation aimed at undermining democracies and justifying Russia's war in Ukraine.

The United States is among the small number of countries that are non-compliant with the Financial Action Task Force's (FATF) Recommendation 22, which governs customer due diligence and recordkeeping requirements for non-financial businesses and professions. As a result, it does not require enablers to look out for and report dirty money, said Josh Rudolph, fellow for malign finance at the Alliance for Securing Democracy at the German Marshall Fund think tank.

In October 2021, bipartisan US lawmakers introduced the ENABLERS Act that would force lawyers, accountants, public relations firms, and third-party payment service providers to conduct due diligence on the sources of funds. For the ENABLERS Act bill to be passed into law, legislators must overcome stiff resistance from what Rudolph calls the "four horsemen": the legal profession, company formation agents, accountants, as well as covert public relations and marketing companies.

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"Legal professionals are the single-most important enabler sector to regulate because they are the most useful to oligarchs and kleptocrats looking to secretly funnel dirty money through law firms' bank accounts," Rudolph told the UK Royal United Services Institute. "Lawyers are the most obstinate and organized group in their resistance to AML rules. The American Bar Association (ABA) has spent a quarter-century in this war of attrition with the FATF."

The legislative strategy surrounding the passing of the ENABLERS Act must be very carefully thought out, including at the stage of scoping the statutory language, Rudolph added.

"[What] this bill will do is important and has to be accompanied by political strategies to divide and conquer the ABA."

The bill has gotten new momentum this year through being included in the House version of a defense budget bill that regularly passes Congress. However, its prospects in the Senate and potential for revision remained fluid. If Congress fails to pass the legislation, however, the US Treasury would instead be forced into playing "small ball," perhaps by repealing some of the enabler exemptions in the previously passed Bank Secrecy Act, Rudolph said.

Asset flight by Russian oligarchs a growing problem

Not surprisingly, Russian oligarchs and their acolytes are increasingly seeking to bypass sanctions by moving property and assets in and out of jurisdictions, making the job of tracking key information such as beneficial ownership ever harder.

The crisis has also exposed shortcomings in the UK's asset-freezing and seizure regime. Oligarchs have also been allowed to avoid designations of the UK's sanctioning regime, even if foreign jurisdictions have named them and added them to lists. The UK's lists differ from those of the EU and of the United States.

On July 12, the National Crime Agency and HM Treasury's Office for Sanctions Implementation (OFSI) issued a red alert on financial sanctions evasion typologies used by "Russian elites and enablers." The alert was aimed at providing information about common techniques used by designated persons and enablers to evade financial sanctions.

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Indeed, lawyers have felt a similar frustration with UK practice, noting that EU countries have sanctioned more individuals and companies than the UK.

"The EU has sanctioned a number of well-known oligarchs, some of whom have close links to or live in the UK, whom the UK have not sanctioned," said Barry Vitou, a partner at HFW in London.

"Against a backdrop where the government has been loudly trumpeting the power to make unexplained wealth orders [UWOs] and take assets away from those whom [the government claims] have been involved in the theft of assets from their home country, there have hardly been any successful examples since their introduction," Vitou said, adding that, for example, no UWOs were reportedly obtained last year.

Lack of compliance resources

Existing law of civil forfeiture gives authorities power to restrain oligarchs' properties, but enforcement is lacking because of limited resources. The National Crime Agency, the Crown Prosecution Service, and the Serious Fraud Office lack sufficient risk capital to take on these cases, said Michael Levi, professor of criminology at the University of Cardiff. And if these agencies move forward and lose, it tends to hobble them in the long run so that other prospective witnesses get frightened off.

The UK approach contrasts with that in the United States, where the US Department of Justice (DOJ) has seized large numbers of properties from those suspected of corruption. "The use of civil forfeiture to seize properties bought with the proceeds of crime is something we are very experienced at doing," said Stefan Cassella, a former deputy head of the DOJ's Asset Forfeiture and Money Laundering Section.

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> ***– Stefan Cassella, a former deputy head of the DOJ's Asset Forfeiture and Money Laundering Section***

Such a process is extremely time- and resource-intensive, Cassella said. Officials must have established a strong legal case to show the crime that funded the purchase of the assets before any law enforcement agents can move in. US legislation enables law enforcement to seize property that has been acquired through bribery and corruption. "Whole rooms of agents will be dedicated to the investigation of a single property," Cassella explained. "But when we move, we are very aggressive. We know that the opposite side will be well-resourced themselves and they will use every legal device. These cases can go on for two years." The DOJ has won successful cases against politically exposed foreign politicians allegedly involved in bribery in West Africa and Pakistan, among other countries.

Civil forfeiture law is used in both the United States and the UK. And a law that was the basis of the Asset Recovery Agency, which has since folded, is in place in the UK and could be used to go against oligarchs.

Oligarchs expecting to be sanctioned may well be removing their wealth from the UK and other jurisdictions, said Justine Walker, head of global sanctions and risk at the Association of Certified Anti-Money Laundering Specialists (ACAMS) and former director of sanctions policy at UK Finance.

In a novel twist on the use of sanctions, the UK imposed cyber-sanctions on a Russian website and eight individuals for operating social media misinformation organizations, commonly known as troll farms. The move, in March, was the first time the OFSI had updated its cyber-sanctions list since it was originally published in 2019.

Conclusion

The sanctions stemming from Russia's invasion of Ukraine are far more complex and far-reaching than anything seen before. Russia is much larger and more economically intertwined than countries that have featured in previous broad sanctions regimes, such as North Korea or Iran.

Indeed, the flurry of activity since Russia's invasion of Ukraine has been dubbed the "Super Bowl of sanctions." This has meant that meticulous reviews, extensive documentation, and a cautious approach are essential for all parties involved, such as banks, financial service firms, private fund managers, and other parties.

All should be aware that their activities around how they handle sanctions coming from multiple countries will likely be scrutinized in future due diligence and regulatory inquiries and reviews for some time to come.

Credits

This white paper was authored by the Thomson Reuters Regulatory Intelligence group:

Editors: Randall A. Mikkelsen in Boston
Alexander Robson in London

Reporters: Rachel Wolcott in London
Brett Wolf in St. Louis
Todd Ehret in New York

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