



FATF Report

Money Laundering vulnerabilities of Free Trade Zones

March 2010



THE FINANCIAL ACTION TASK FORCE (FATF)

The Financial Action Task Force (FATF) is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing. Recommendations issued by the FATF define criminal justice and regulatory measures that should be implemented to counter this problem. These Recommendations also include international co-operation and preventive measures to be taken by financial institutions and others such as casinos, real estate dealers, lawyers and accountants. The FATF Recommendations are recognised as the global anti-money laundering (AML) and counter-terrorist financing (CFT) standard.

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EXECUTIVE SUMMARY

1. Free Trade Zones (FTZs) have proliferated in recent years, such that today there are approximately 3 000 FTZs¹ in 135 countries around the world with a total turnover in the billions of U.S. dollars.² FTZs are designated areas within jurisdictions in which incentives are offered to support the development of exports, foreign direct investment (FDI), and local employment. These incentives include exemptions from duty and taxes, simplified administrative procedures, and the duty free importation of raw materials, machinery, parts and equipment. In addition to boosting economic opportunity, these incentives can result in a reduction in finance and trade controls and enforcement, creating opportunities for money laundering and the financing of terrorism. Because the same characteristics that make FTZs attractive to legitimate business also attract abuse by illicit actors, FTZs are a concern that the Financial Action Task Force (FATF) should address.

2. The case studies included in this report illustrate ways in which FTZs are misused for money laundering and terrorist financing. In particular, the cases highlight the following systemic weaknesses that make FTZs vulnerable to abuse:

- Inadequate anti-money laundering (AML) and combating the financing of terrorism (CFT) safeguards;
- Relaxed oversight by competent domestic authorities;
- Weak procedures to inspect goods and register legal entities, including inadequate record-keeping and information technology systems; and
- Lack of adequate coordination and cooperation between zone and Customs authorities.

3. Further examination of the vulnerabilities highlighted in the case studies allowed for the development of ML/TF risk indicators related to financial transactions, unusual business activity, and trade-based money laundering (TBML) which takes place within FTZs.

4. Although this is the first global report to address FTZs, this is not the first time that the money laundering and terrorist financing vulnerabilities of FTZs have been identified. Through the work of the Caribbean Financial Action Task Force (CFATF) and Aruba a number of best practice elements have been

¹ The geographic area in which special regulatory and tax treatment is applied to certain trade-related products and services, which in this paper is referred to as a free trade zone, is also known by various other names throughout the world, including: free zones, freeport zones, port free trade zones, foreign trade zones, e-zones, duty free trade zones, commercial free trade zones, export processing zones, logistic zones, trade development zones, industrial zones/parks/areas, hi-tech industry parks, hi-tech and neo-tech industrial development zones, investment zones, bonded zones, special economic zones, economic development zones, economic and technological development zones, resource economic development zones and border economic cooperation zones.

² Akinci, G. and Crittle, J. (2008).

developed. The World Customs Organization, the only global standard setter of free trade zones, has also developed reference tools for the development of FTZs. Finally, the FATF TBML Typologies and Best Practices Papers³ published in 2006 and 2008 respectively presented red flag indicators and best practices relevant to FTZs.

5. The misuse of free trade zones impacts all jurisdictions including those without FTZs of their own, because goods can originate from or be transhipped through FTZs not subject to adequate export controls. Proliferators of weapons of mass destruction (WMD) abuse FTZs to tranship dual use goods and to disguise the final destination of sensitive items. FTZs can also be used to create legal entities and access the international financial system, providing opportunities to launder illicit proceeds. Many major zones are also located in regional financial centres linking international trade hubs with access to global centres of finance.

6. Free trade zones are central to the integrated global economy. They stimulate economic growth and play a central role in business for many countries and leading manufacturers. The relevance of FTZs continues to grow as globalization defines economic progress. However the standards, oversight, and regulations governing FTZs have not kept pace with these developments. As a result, illicit actors have been able to take advantage of relaxed oversight and the lack of transparency in zones to launder the proceeds of crime, finance terrorism, and facilitate WMD proliferation.

³ See www.fatf-gafi.org.

CHAPTER 1: INTRODUCTION

1.1 Need for the Typology

7. Free trade zones (FTZs) present a unique money laundering and terrorist financing threat because of their special status within jurisdictions as areas where certain administrative and oversight procedures are reduced or eliminated in order to boost economic growth through trade. Jurisdictions throughout the world create these designated areas, which go by many names. For the purposes of this paper, these areas are referred to as FTZs. The special tax and administrative arrangements available to exporters and export service providers in FTZs, although intended to boost legitimate trade, can create money laundering and terrorist financing vulnerabilities.

8. Other typologies reports have addressed related vulnerabilities, notably the Trade Based Money Laundering (TBML) typology report and TBML Best Practices Paper published in June 2006 and June 2008 respectively. While these reports were instructive, they did not fully address the vulnerabilities nor the scope of techniques utilized by illicit actors in part because they did not take into account the estimated 3 000 FTZs that play a significant role in global trade and which attract substantial funds that are associated with cross-border transactions.

1.2 Scope

9. This report presents the first completed attempt at the international level to identify and address the money laundering and terrorist financing vulnerabilities of FTZs. The report also addresses potential shortcomings in the FATF's current AML/CFT framework.

10. The objectives of this typology report are to:

- Understand the size, scope, definition, and role of FTZs worldwide and their role in the global economy;
- Identify the money laundering and terrorist financing threats and vulnerabilities associated with FTZs;
- Identify the methods used to move and launder the proceeds of crime and/or finance terrorism using FTZs; and
- Suggest areas for further consideration to improve the AML/CFT framework concerning FTZs.

1.3 Methodology

11. In preparing this report, the project team utilized a number of resources. First, the project team conducted a thorough literature review, referencing work conducted by international organizations, trade associations, and academia. The project team also developed a comprehensive questionnaire that was distributed to FATF members and observers in January 2009, which produced valuable information. Finally, the project team engaged the private sector and international organizations. Using these research tools the project team was able to identify: (i) the characteristics that define FTZs; (ii) the number and

scope of FTZs around the world; (iii) the types of activities serviced by the FTZs; and (iv) the AML/CFT vulnerabilities associated with FTZs. In addition to identifying the AML/CTF vulnerabilities, the project team reviewed the scope of measures that exist to reduce the threat of ML/FT in FTZs. This stage incorporated work conducted to date on TBML and interviews with free trade zone authorities and merchants. This background and research have provided a means for the team to evaluate the extent to which ML/TF vulnerabilities are mitigated and assess whether safeguards need to be strengthened, and if so how that might be done.

12. The project invited a wide range of participation from the international community in the spirit of sharing experiences and knowledge. It encouraged international cooperation with a view toward the development of a uniform framework for regulating international trade systems in FTZs. The project team was co-chaired by Belgium and the United States and was composed of Aruba, Australia, the CFATF, Singapore, and the World Customs Organization (WCO).

CHAPTER 2: THE ROLE AND SCOPE OF FREE TRADE ZONES

2.1 Definition

13. FTZs are created within jurisdictions to promote trade, support new business formation, and encourage foreign direct investment. They provide a preferential environment for goods and services primarily associated with exports, whereby a minimum level of regulation is imposed on those companies approved to operate within the zone. Additional benefits include exemptions from duty and taxes, simplified administrative procedures and duty free imports of raw materials, machinery, parts and equipment.

14. There are as many names for these specially designated trade-promotion areas as there are countries that conduct international trade. In addition to free trade zone, some of the other common terms for these areas include special economic zones, foreign trade zones, and export processing zones. The International Convention on the Simplification and Harmonization of Customs Procedures (Revised Kyoto Convention) uses the term “free zones,” which the revised convention describes as “a part of the territory of a Contracting Party where any goods introduced are generally regarded, *insofar as import duties and taxes are concerned*, as being outside the Customs territory”⁴.

15. Respondents to the project team’s FTZ questionnaire noted there is more than one kind of zone and although all may exist “outside the customs territory” each area exists to facilitate a certain activity, such as manufacturing, processing, warehousing, storage, and transshipment. Some respondents indicated their FTZs were more than work zones, as they can include on-site housing, retail establishments, financial services, even tourism and gambling.

16. Generally an FTZ is an area or regime within a country with a special status concerning customs and/or tax controls, in which enterprises are licensed to conduct business or provide services for export and/or import purposes though the granting of special incentives to stimulate their development. There is a separate customs area providing duty free benefits and streamlined procedures to promote international trade. Generally there is single management and/or administration, although a number of different organizations, private and public, may be involved in the management and operation of a zone.

17. Logistically, zones are most often located near ports of entry; air, land or sea, but operate apart from traditional ports of entry and often under different rules. This location facilitates entry to the zone as well as the exit and entry to the customs territory. It also provides Customs officials with easier access to the port and FTZ. Prohibited merchandise, items that are forbidden by law to enter a jurisdiction, cannot generally be admitted to an FTZ but certain types of restricted merchandise such as items which may require a special license or permit may be allowed. In most cases merchandise entering and exiting an FTZ must be accompanied by commercial documents, for example a bill of lading and a commercial invoice.

⁴ World Customs Organisation (1999).

Tracking is conducted through a mix of paper and IT systems, depending on the zone, however many use both. Most FTZs inspect some percentage of cargo entering the zone, but this varies widely.⁵

2.2 Evolution

18. FTZs have played a role in global trade since ancient times. Beginning in the 18th century these zones became central locations on international trade routes serving as hubs for trade and transshipment. Examples of these centres included Gibraltar (1704), Singapore (1819) and Copenhagen (1891). The first modern zone was established in 1959 as the Shannon Free Zone in Ireland, the world's first duty free industrial location targeting industries that would use the airport to move both people and freight. The zone was very successful at turning the local economy around and subsequently serving as a model for future free zones around the world.⁶

19. Zone development has moved away from one rigid definition of a FTZ and today has evolved as zones and their roles in different economies is reflected through a wide range of different types of zones with features tailored to the purpose of the zone including foreign direct investment (FDI), economic development, and employment generation, among others.

20. Today the range of zones generally falls into one of the following categories.⁷

Free trade zones (FTZs); these are typically general purpose fenced in, duty-free areas offering warehousing, storage and distribution facilities for trade, transshipment, and re-export of products. These are located in most ports around the world.

Examples: Colon Free Zone, Panama, and Singapore

Export Processing Zones (EPZs) are industrial areas focusing on assembly and manufacturing of intermediate imports aimed primarily but not exclusively at foreign markets. Particular sectors include labor-intensive, light manufacturing such as garment production and the assembly of electronics. EPZs also promote linkages with the domestic economy by encouraging technology transfer and innovative industrial strategies. Certain types of EPZs are sometimes called **Hybrid Export Processing Zones** because they combine the traditional export focus of an EPZ with a sub-divided area in which non-export oriented activities can take place.

Example: Karachi, Pakistan

Enterprise zones are economic development areas intended to revitalize specific urban or rural areas where they are located through tax incentives and financial grants. These are most often found in the developed world.

Example: Docklands, London

Freeports typically the largest of the zones, accommodate all types of activities including tourism, retail sales, and on-site residence, and accompany a broader set of incentives and benefits. Freeports are different from traditional FTZs as they are not seen as export drivers but areas promoting overall economic growth linking the zones with the overall economy of the nation. This has also resulted in greater expansion and liberalization of the core set of policies

⁵ FATF FTZ Questionnaire Analysis.

⁶ Akinci *et al*, p. 9.

⁷ Akinci *et al*, p. 10.

present in most free zone programs. The European Union allows inward processing relief and other customs schemes that produce some of the benefits of free zones without requiring formal zone definition. In the UK, for example, free ports do not offer significant benefits beyond inbound processing relief schemes. As a consequence ports like Rotterdam have marketed themselves as “freer than a Freeport”.

Example: Hong Kong, China

Single factory EPZ schemes provide incentives similar to export processing zones but are not a zone at all, rather a single factory located anywhere in a country which receives the special duty free privileges of zones. In the United States they are also called sub-zones.

Example: Mauritius and Madagascar are examples of where Single Factory EPZs exist.

Foreign Trade Zones is the name of the specially designated zones in the United States. They are established in or adjacent to a port of entry in which all types of merchandise may be held without being subject to U.S. Customs duties and other taxes.

Special Economic Zones (SEZs): SEZs extend the relaxed tax and administration characteristics of FTZs to investment arrangements, labour laws, management practices, and wage rate policies in specific areas of the country. Originally this structure applied only to China but versions now exist in India and elsewhere. China has proposed applying special treatment within SEZs to promotion of real estate, tourism, infrastructure development and banking.

Snapshot: Shenzhen, China

The Shenzhen Special Economic Zone (SEZ) was founded in 1980 as the first in China. It is nearly 2 000 square kilometres, has over 12 million inhabitants and a GDP in 2006 of USD 71.3 billion. The SEZ has significantly contributed to the transformation of Shenzhen from a fishing village to a major industrial and financial centre which has benefited tremendously from the liberal economic policies granted to the SEZ. As the first Chinese SEZ, Shenzhen has served as a pilot for market oriented reforms. Shenzhen enjoys the most liberal economic policies in China both in terms of FDI and engaging in international trade. Examples of the pilot reforms include differential corporate tax rates for foreign and domestic firms. Migrants from across China account for 83% of the population of Shenzhen and less than 6% are over the age of 60. This combination has led to an innovative economic environment. Shenzhen has also built its success on the availability of capital. In 2005, one third of the total number of venture capital firms in the whole country was located in Shenzhen. Foreign direct investment (FDI) has played a major role in the development of Shenzhen. Toshiba, Epson, Wal-Mart, Sony and IBM are major investors. 141 of the world's top 500 multinational companies have invested in Shenzhen.

The story of the Shenzhen zone is multi-faceted as the SEZ hosts hundreds of other national level zones with special incentive regimes. Within Shenzhen there are 15 free trade zones, 17 export processing zones, 5 economic and technological developments zones, 53 high technology developments zones and 15 border economic cooperative areas.⁸

Bonded Warehouses: Specially designated storage warehouses that have the authorization of Customs authorities.

⁸ Zhang Yansheng (2007).

Snapshot: Mexican Maquiladora Program

With the aim to further direct foreign investment, the Mexican government developed administrative programs that bring fiscal benefits and administrative eases to resident enterprises involved in the elaboration, reparation or transformation of merchandises (enterprises commonly known as “*maquiladoras*”). Such programs authorise the temporary import of goods exempt from general import tax; value added tax and other duties, given that such merchandises are resented off abroad upon concluding the makeover process (which regularly lasts 18 months).

If temporarily imported merchandises are not dispatched promptly, they become definitive trade in goods, subject to customary trade duties.

Joint investigations and co-ordinated operational strategies allowed Mexican authorities to identify an important universe of companies that had failed to return on time exempted goods.

According to Customs Law, those who introduce or extract merchandises omitting the total or partial payment of trade duties commit contraband.

Some of those companies simply omitted to return the goods, while others engaged as well in simulation acts to fake timely deliveries. All of them affected the federal treasury and severely damage the national economy, as illegal commodities are traded in the informal market, generating unfair competition and impunity.

Such criminal activities generate large profits that are reinvested unevenly so as to hide their illicit origin or give them the appearance of legitimacy. In one year, the Ministry of Finance in Mexico has conducted investigations and integrated criminal cases based on this typology with an historic aggregated economic damage that adds up to roughly 58% of the annual budget allocated to the General Attorney’s Office or 75% of the annual budget allocated to the Ministry of the Interior.

In addition to the zones above, there are a number of highly specialized zones promoting a specific industry such as information technology, tourism, or heavy industry. The location varies depending on the sector. Sites can be found adjacent to universities, ports or other relevant hubs of activities relevant to that sector.

Examples: Labuan Offshore Financial Centre, Malaysia and Dubai Internet City, UAE

21. With regard to their role in attracting new businesses, the following table describes the Zone Concepts in Selected Developing and Transition Economies.

	Traditional EPZ Model	Hybrid EPZ Model	Commercial Free Zone	Single Factory	Freeport
Asia and the Pacific	Taiwan, China Korea, Rep. of Indonesia Vietnam Philippines Bangladesh India Malaysia Pakistan Sri Lanka	China Indonesia Lao PDR Korea, Democratic People’s Republic of Philippines Thailand Vietnam	China Japan Malaysia	Fiji	China Hong Kong, China India Indonesia Korea, Rep. of Macau Malaysia Philippines Singapore
Americas	Argentina Bahamas Belize Dominican Republic Guatemala Jamaica Nicaragua Peru Trinidad and Tobago Uruguay Venezuela, R.B. de	Bolivia Brazil Colombia Costa Rica Cuba Ecuador El Salvador Haiti Honduras	Argentina Bahamas Belize Brazil Canada Colombia Curacao Panama	Jamaica Mexico	Bahamas Chile Colombia Panama

	Traditional EPZ Model	Hybrid EPZ Model	Commercial Free Zone	Single Factory	Freeport
Middle East and North Africa	Algeria Iran, Islamic Rep. of Sudan	Bahrain Egypt, Arab Rep. of Syrian Arab Rep. Tunisia Turkey United Arab Emirates	Israel Jordan Kuwait Lebanon Libya Morocco Oman Tunisia Turkey United Arab Emirates Yemen, Republic of		Iran, Islamic Rep. of of Jordan
Central and Eastern Europe and Central Asia	Slovenia	Belarus Albania Bosnia and Herzegovina Bulgaria Croatia Hungary Kazakhstan Kyrgyz Republic Latvia Lithuania Macedonia, FYR Moldova Poland Ukraine	Czech Republic Estonia Latvia Romania Serbia Montenegro Slovak Republic Ukraine Uzbekistan		Russian Federation
Sub-Saharan Africa	Cameroon Cape Verde Equatorial Guinea Gambia, The Ghana Kenya Mozambique Namibia Nigeria Senegal South Africa Tanzania Togo Uganda Zambia Zimbabwe		Benin Djibouti Gabon Liberia Mauritius Tanzania Togo	Burundi Madagascar Malawi Mali Mauritius Senegal Seychelles	

Source: BearingPoint, ILO database; WEPZA (2007); FIAS research.

22. Today there are approximately 3 000 zones in 135 countries worldwide.⁹ In 2007, total exports from FTZs were estimated at USD 400 billion.¹⁰ The Colon Free Zone in Panama, the world's second largest FTZ, generated USD 8.6 billion in exports and re-exports in 2008.¹¹ Zones play a vital role in

⁹ Akinci *et al* (2008), p. 7.

¹⁰ Akinci *et al.* (2008) These statistics were derived from a database developed by FIAS in close consultation with the World Economic Processing Zones Association (WEPZA), and the International Labor Organization (ILO). Date from an ILO document dates April 2007.

¹¹ U.S. Department of Commerce (2007).

economic growth and development through increased exports, foreign exchange earnings, and employment generation. Other zones serve as catalysts for innovation, bringing new industry knowledge and manufacturing to an economy and a region. Single factories can also be granted the same special status as FTZs, which allows for a manufacturer to benefit from the regime without being subject to the geographic constraints most often associated with FTZs.

23. Modern zones have played a significant role in the global economy since the middle of the 20th century and they continue to develop and change to meet the demands of international businesses. There has been a tremendous growth in FTZs globally in the last four decades. Zones began to develop in Latin America and East Asia throughout the 1960s and 1970s and new development in South Asia, South America and sub-Saharan Africa began in the 1980s followed closely by new programs in Central and Eastern Europe, the Middle East and North Africa. In 1970, 30 countries had 80 free zones with exports totalling USD 6 billion. Overall a few regions and countries have the largest concentration of FTZs. The United States has 161 active zones and exported more than USD 40 billion¹²; China leads Asia with 187 EPZs with total exports of USD 145 billion followed by Indonesia, Philippines, Thailand, India, Taiwan and S. Korea.¹³ Generally, Hybrid EPZs are the preferred model in many Central and Eastern European countries as well as in many Latin American countries. Free Trade Zones have been the traditional choice among Middle Eastern and North African countries but are a relatively recent introduction in Asia where zone development has focused on export manufacturing and therefore the EPZ and SEZ models.

2.3 Privatization

24. The way FTZs have been owned, operated, regulated, and governed over the past 30 years has changed dramatically. The greatest shift has been from public to private sector development, ownership, and operation of zones worldwide. In 2005, 62% of the 2 301 zones in developing countries were private sector developments compared to the 1980s when less than 25% of the zones worldwide were private¹⁴. This shift has been a result of the knowledge that zones can be very profitable when one operator takes on a number of elements of zone administration, taking advantage of economies of scale. In addition to those zones that are 100% privately owned and operated, a number of public-private partnerships have been developed. Governments also provide incentives to private zone developers.

Private and Public Sector Zones in Developing and Transition Economies ¹⁵			
Region	Public Zones	Private Zones	Total
Americas	146	394	540
Asia and Pacific	435	556	991
Sub-Saharan Africa	49	65	114
MENA	173	40	213
Central/Eastern Europe and Central Asia	69	374	443
Total	872	1 429	2 301

25. The wave of privatization has provided tremendous liberalization in zone development which has resulted in the creation of more FTZs with expanding purpose and privileges and greater automation to simplify bureaucratic procedures. Zones have a far more varied clientele now including retailers, housing and professional services.

¹² Free Trade Zones Board (2009).

¹³ Akinci *et al* (2008), p. 27.

¹⁴ Akinci *et al* (2008), p. 2.

¹⁵ Akinci *et al.* (2008).

26. Different countries have adopted different models for the operation of zones. In some, public authorities operate the zones directly. In others zones are designated by government and then run by private sector operators. There are other combinations. In some countries the zone authority becomes almost a substitute ministry and can provide a one-stop shop for government services, avoiding bureaucracy, delay and other problems. Many countries believe that zones provide a way of kick-starting export-led, economic development and modernising legislation. Zones can pilot internationally competitive regimes ahead of economic reform applying to the entire territory of a state. There can be spill-over effects as development in the zone enriches its surrounding region.

CHAPTER 3: VULNERABILITIES OF FREE TRADE ZONES

27. As specific operating areas, zones vary widely from country to country and within an individual jurisdiction the operators, regulators and requirements may be different. As there are not necessarily standard approaches within zones it can be a complex matter from which to gain a global snapshot. As separate customs areas created to encourage trade and foreign direct investment, FTZs are subject to unique laws, regulations, and oversight to take account of their role in job creation and economic development policies. These features provide opportunities for legitimate business but also present weaknesses which expose it to misuse by criminal elements. The existence of vulnerabilities in a system makes it attractive for money launderers and terrorist financiers. Although zones vary in order to provide different benefits to countries and regions, they present similarities with regard to their vulnerabilities which are developed through the report.

3.1 Application of AML/CFT measures in Free Trade Zones

28. AML/CFT standards and guidance which address this specific sector (*i.e.*, FTZ) are relatively new although the CFATF and Aruba in particular have been researching and attempting to address this issue for several years. While there is a great deal of knowledge and awareness of AML/CFT issues within the financial sector, this knowledge and awareness does not often extend to businesses and in FTZs.

29. Many of the rules and regulations governing FTZs are outdated. Over the past 30 years FTZs have been developing rapidly, not always keeping up with the latest AML/CFT legal and regulatory developments. As such, many of the laws and regulations governing FTZ don't take into account the ML/TF vulnerabilities and the risk of illegal activities. Therefore, a clear challenge of FTZs is the unique balance of promoting a business friendly, open environment with the vulnerabilities that can arise in a uniquely operated area with minimal or no regulatory oversight.

30. A number of jurisdictions do not apply the same AML/CFT regulations in the zone as in the rest of the country. In particular the regulations that relate to preventative measures such as reporting large-value currency transactions and, in some cases, Suspicious Transaction Reports (STRs) as they relate to financial institutions and businesses operating in the zones.

31. Perhaps more importantly, some businesses located in FTZs fall outside of the AML/CFT legal and regulatory framework because their activity or operation falls outside the scope of those traditional financial sector providers located onshore. Therefore, the AML/CFT provisions don't apply to businesses and activities within these special areas.

32. As mentioned above, the use of cash in FTZs continues to be important because it is easy to use in trade transactions. Cash does not require financial institutions and presents particular ML/TF risks because of its portability, anonymity and lack of an audit trail. Moreover, even if banks outside of the FTZs are involved in the trade transactions, they are less able to manage ML/TF risks because of the others vulnerabilities of the zones (opaqueness and relaxed oversight). However financial institutions in FTZs also present risks which are examined through red flag indicators in the following chapter. In this respect, the integration of cash into a jurisdiction's financial system is often facilitated by the presence of financial institutions in the zones.

3.2 Relaxed Oversight and Lack of Transparency

33. The scope and degree of Customs control over the goods introduced, and the economic operations carried out in FTZs, vary from one jurisdiction to another. Consistent with the purposes of establishing free trade zones, goods introduced in a FTZ are generally not subject to the usual Customs controls. There is therefore a risk of exploiting the FTZ system for commercial fraud.

34. Goods introduced in a FTZ can undergo various economic operations, such as transshipment, assembly, manufacturing, processing, warehousing, re-packaging and re-labelling as well as storage for timely marketing, delivery and transshipment. The tracking of shipments, especially for repackaging is a key element in the control of FTZs. The same shipment may use FTZs as a base around the globe for no other purpose than to launder funds.

35. Although the conditions for setting up FTZs may be regulated by the Customs or relevant management authority, and the kinds of operations may be subject to the approval of these authorities, the degree of Customs intervention is often insufficient or even absent. Commercial operations carried out under such lenient controls can lead to cutting off the monitoring of the international supply chain.

36. Licensing procedures and supervision of activities in FTZs are often complicated and bureaucratic which can lead to insufficient oversight. There is a lack of clarity regarding regulations covering the control of free trade zones. In some cases it is not clear if the government or the Customs authorities have the jurisdiction to exercise controls. The lack of control by Customs raises problems in the fields of intellectual property, security of the supply chain, valuation fraud and other non-fiscal offences.

37. Finally, responses to the questionnaire indicate that the controls are often carried out by random selection more than on risk assessment or indicators and that no clear procedure, authority, or documentation is identified to organize and execute the examinations.

38. Possible actions to prevent and detect commercial fraud cases exploiting free trade zone systems should be examined from two different viewpoints, namely *i*) maintenance of appropriate level of Customs control over the admissibility of goods and the business operations carried out, and *ii*) appropriate assessment of the risk associated with goods arriving from free zones.

39. Most zone authorities operate separate company formation services from those that exist in the rest of the jurisdiction and market the ease of setting up a legal entity in an FTZ to attract business. Many zone authorities request little or no ownership information of the companies interested in setting up in the zone. As a result, it is simpler for legal entities to set up FTZs and hide the name(s) of the true beneficial owners. FTZs that offer company formation services also by-pass AML regulations that may apply to the legal entity formation process outside of the zone. This provides a means to access the financial system in the same jurisdiction or others offshore. Legal entities setting up in FTZs should be subject to the same requirements as legal entities in the rest of the country. This would provide for greater transparency within the country and provide substantial assistance to law enforcement when conducting investigations into companies for money laundering, tax evasion, or other criminal activity.

40. Analysis of the questionnaire responses showed that jurisdictions permitted a wide array of documents and procedures to set up businesses in FTZs and that in all cases the zone authority must approve the business operations. The questionnaire responses also verified the lack of beneficial ownership information or AML obligations as it relates to company formation. The responses also established that physical presence in the zone is not always a requirement for establishment in the area. The case studies also demonstrate this is clearly an area to examine in order to address the need for greater transparency globally in regard to the businesses operating in the zones.

3.3 Lack of Systems Coordination

41. Customs document management and administration varies by region, country and individual customs area including FTZs. Theoretically zone transactions must be reported to zone authorities and Customs authorities, however there are two different most often not integrated systems. Overwhelmingly Customs authorities use a mix of software and paper to monitor shipments in and out of FTZ and Customs Bonded Warehouses (CBW) internationally. The lack of a clear standard related to Customs clearance makes it very difficult to monitor. Most FTZs software systems, if they exist, are not integrated to the Customs IT systems which include all ports. A paper based system or a hybrid of paper and IT as it is in most cases requires longer to monitor and check against related documents (in-bound vs. outbound). It is also difficult to analyze data for trends related to specific ports, zones, regions or businesses.

42. The questionnaire confirmed that a majority of jurisdictions use a mix of paper and IT-based systems and that few are fully integrated. Six out of ten questionnaire responses showed that zone management used a mix of IT and paper-based systems to track incoming and outgoing shipments into the zone. Six out of ten questionnaire responses also indicated that Customs used a mix of IT and paper systems. Only two responses to the questionnaire indicated that the data from the zone authority and the Customs authority were integrated using computer software. This reflects a lack of coordination between Customs systems and zone management systems. In addition to Customs and zone authorities, additional federal or State regulatory or law enforcement authorities may be involved in various capacities within the zone. The operational cooperation and coordination between competent authorities needs to be addressed to avoid a gap in the control of FTZs including the role of FIUs.

3.4 Vulnerable Types of Goods

43. Certain types of goods are particularly vulnerable due to their value, size, high tariff rate, volume of trade and potential for IPR violations. Any one or a combination of these elements makes them attractive for potential misuse, especially via FTZs, because of their role as an open platform for trade and the businesses operating in these zones.

Cigarettes, Alcohol and other high tariff items

44. Cigarettes, alcohol, and other high duty items are more vulnerable to smuggling and contraband due to the increased revenue that can be generated by not paying tax. The high volume of containers, the ease of repackaging and relabeling shipments within the zones, and the lack of oversight make FTZs rife for exploitation of smugglers attempting to avoid high duty and tax rates on cigarettes and alcohol. Historically some jurisdictions such as Aruba developed a parallel market for cigarettes, notably for the Colombian market. This market was the result of agreements between the manufacturers and licensed distributors, whereby cigarettes were “smuggled” into the country with the alleged knowledge of the manufacturers and distributors. The goods purchased by Colombians left Aruba legally, only to be smuggled into Colombia.

Luxury Goods and other goods most often used in violation of IPR

45. IPR violations are difficult to detect and are difficult to substantiate at the time of the cargo inspection. In an environment with few inspections and large cargo coming in and out, it would be relatively easy to take advantage of relaxed oversight in order to import, repackage, re-label and export textiles or IT equipment into the country or onto a third country. Repackaging in FTZs is one of the tools used by criminals to cut the links with the real country of origin or destination.

Carrousel VAT and electronic items

46. Electronic items constitute high volume of trade and are therefore more vulnerable for VAT carrousel fraud where tax is illicitly reclaimed. The higher the volume, the higher the refunds will be. FTZs can be misused in these fraud schemes because they offer a large market with relaxed oversight for the trade of the items concerned.

CHAPTER 4: FREE TRADE ZONES AS A METHOD USED BY ILLICIT ACTORS

47. The cases described under section 4.3 demonstrate the ML/TF risks and vulnerabilities associated with FTZs which were identified in the previous chapter. These cases illustrate how FTZs have been exploited by criminals as a means to initiate and facilitate illicit financial activity to include traditional and complex money laundering techniques. Moreover, FTZs are misused to commit the predicate offense (*e.g.*, smuggling) and to facilitate the laundering of the illicit proceeds.

4.1 Predicates

48. Responses to the FTZ project team questionnaire show a variety of ways that FTZs can be misused in order to move and launder the proceeds of crime and/or to finance terrorism. In cases of money laundering within FTZs, 19 predicate offenses were identified. The most commonly identified predicates were: participation in an organized criminal group and racketeering, illicit trafficking in narcotics, fraud, counterfeiting and piracy of products, and smuggling. A number of countries also listed illicit arms trafficking, illicit trafficking in stolen or other goods, and forgery.

Predicate Crime	Number of Responses from the FTZ Questionnaire
Participation in an organized criminal group and racketeering	6
Terrorism, including terrorist financing	1
Trafficking in human beings and migrant smuggling	2
Sexual exploitation, including sexual exploitation of children	1
Illicit trafficking in narcotics	8
Illicit trafficking in stolen or other goods	4
Corruption and bribery	3
Fraud	6
Counterfeiting currency	1
Counterfeiting and piracy of products	6
Environmental crime	0
Murder, grievous bodily injury	0
Kidnapping, illegal restraint and hostage-taking	1
Robbery or theft	2
Smuggling	9
Extortion	2
Forgery	4
Piracy	2
Insider trading and market manipulation	1

4.2 Trade Based Money Laundering

49. TBML is one of three main methods by which illicit actors launder the proceeds of crime. TBML schemes include under and over-invoicing, phantom shipments and other falsification of the value or quantity of a shipment including multiple invoicing of goods in order to justify the transfer of value from one jurisdiction to another. However TBML schemes often include a number of complex layers including cash, front companies, currency exchange, and the purchase and shipment of goods with illicit proceeds.

50. The FATF has looked at the vulnerabilities associated with the misuse of the trade system through the TBML Typologies in 2006 and the Best Practices Paper in 2008, however to date there are no international standards to address TBML. By definition businesses located in FTZs utilize international trade for a majority of transactions and zones facilitate and simplify these transactions. The lack of AML/CFT safeguards related to TBML poses a particular vulnerability in FTZs.

51. A successful TBML scheme often includes false documentation which misrepresents the contents and/or volume of cargo. The size and scope of FTZs, some cities in themselves, makes it difficult to effectively monitor incoming and outgoing cargo, repackaging, and relabeling. Some FTZs export billions of dollars per year but have fewer competent authorities present to monitor and examine cargo and trade transactions. The relaxed oversight in FTZs makes it more challenging to detect illicit activity and provides an opportunity for misuse. As a result, FTZs provide a setting in which certain TBML schemes are more easily conducted.

52. TBML and other money laundering schemes rely on the ability of the perpetrator of the crime to distance themselves with the illicit proceeds. Shell companies enable illicit actors to create a network of legal entities around the world linked to financial institutions. The lack of transparency in the company formation process in FTZs permits companies located in FTZs to create layers of transactions which are difficult if not impossible for law enforcement to follow.

53. The TBML Best Practices Paper suggests ways to improve the collection and effective use of trade data to combat TBML. This is particularly relevant to many FTZs which do not have integrated import and export data from Customs and the zone authority. The lack of trade data which can be effectively mined by law enforcement creates a black hole for investigations and shipments entering and exiting FTZs worldwide. It is significant impediment to effectively combating TBML in FTZs.

54. TBML is easier to perpetrate when a series of systemic vulnerabilities exist in one place. FTZs represent an environment in which this occurs through relaxed oversight, lack of transparency, trade data and systems integration. As a result FTZs facilitate the TBML and related illicit activity.

4.3 Case Studies

Case Study 1: Bulk Cash Smuggling

Large sums of cash were declared to Customs at local airports by couriers who claimed they were bringing cash payments to companies based in the FTZ. The case involved professionals and businesses and a request from jurisdictional authorities following an international ML investigation.

The proceeds of illegal activities (presumably drug trafficking) were amassed in Country I from where the money was transferred briefly to Country II and from there carried on commercial flights to Country III, to the FTZ by cash couriers who were citizens of Country II, of whom 11 were identified.

Once the money had been brought into Country III and declared to the Customs authority the couriers handed it over to individuals in the FTZ where the money was used to pay for merchandise for export.

The scheme was facilitated by local customs brokers, lawyers and other professionals.

Over a period of five months the couriers from Country II brought more than USD 13 400 000.

In this case the cash couriers declared the cash upon entering the country however there was no investigation or discovery of the movement and trends in the movement relevant to the cash. This case illustrates the need for competent authorities to target, identify and investigate suspicious cross-border movement of cash. There was also no additional requirement to declare cash entering the FTZ nor was the requirement for businesses operating in the zone enforced. This lack of AML obligations and enforcement represents a critical AML/CFT vulnerability of FTZs.

Case Study 2: Trade Based Money Laundering/Black Market Peso Exchange/Terrorist Financing

This case involved criminal structures operating in Colombia, Central and South America, Europe, Asia, the Middle East, Mexico and the United States. The investigation uncovered multi-ton quantities of cocaine being shipped to various locations worldwide and uncovered a massive Colombian/Lebanese drug trafficking and money laundering cell operating globally with direct links to the Islamic extremist organization Hezbollah in Lebanon. A portion of the drug proceeds sold in the Middle East was directed to Hezbollah leaders operating in Lebanon to ensure that the traffickers could operate in certain areas in the Middle East.

The network also had a central money laundering operation based in Country I's Asian based commodities trade. The network utilized Asian based financial institutions and trading companies to launder in excess of USD 15 million USD monthly in narcotics proceeds to Colombia via the black market peso exchange (BMPE). Proceeds of drug were sent to Country I based business accounts which were controlled by Colombian business owners who would purchase the currency from peso brokers and ship the goods to South America. Traffickers would receive the money up front or subsequent to the sale of goods. The network was able to funnel narcotics proceeds through Country I back to Colombia to the drug trafficking source. A number of businesses in the Colon Free Zone (CFZ) in Panama participated in this scheme and the zone was a central point of delivery for bulk cash proceeds of drugs.

There was also a related BMPE scheme based in Miami. Electronics companies in Miami would accept drug money from US bank accounts and purchase computer and electronics parts which were shipped to Colombia. The Colombian business owner would sell the parts and transfer the proceeds to the trafficker less a commission.

Transactions between companies in the zone as well as import and export records are maintained on paper and the CFZ administration and Panamanian Customs systems are therefore not integrated making it very difficult for accurate and up to date tracking of shipments in the zone. The lack of transparency of transactions taking place in the zone makes it very difficult to track shipments to and from the zone as well as between companies in the zone, particularly given the size of the CFZ. The zone administrator is currently in the process of updating the system to require companies within the zone to file transactions electronically and there is also a plan for this to be integrated with the Customs system.

Some businesses in the CFZ routinely accept large volumes of cash for wholesale quantities of merchandise. The presence of financial institutions including banks and money services businesses provides further opportunity for the integration of cash into the financial system. Within the CFZ filing cash transaction reports (CTRs) and suspicious transaction reports (STRs) is required of all businesses, however the practice of filing is not enforced and customers paying in cash for goods in the zone are not subject to any customer due diligence procedures. All STRs and CTRs filed in the zone go first to the zone administrator who forwards them on to the financial intelligence unit.

Case Study 3: Smuggling and Tax Evasion

A U.S. company received shipments of alcohol and tobacco from domestic and international suppliers at Customs Bonded Warehouses (CBW) and FTZs. The company would repackage the merchandise and ship it to out under the name of another company to other CBWs and FTZs, ultimately smuggling it into markets for sale. The proceeds were laundered primarily through the purchase of real estate in various jurisdictions. Investigators were able to determine the company behind the criminal activity used double invoicing, false Customs forms, a counterfeit Customs stamp, and forged signatures of Customs officials to facilitate the smuggling, transshipment, and sale of the untaxed cigarettes. One element of the scheme was to sell to foreign diplomats.

During the execution of a search warrant at the U.S. company business location, law enforcement seized USD 947,195 worth of untaxed alcohol and cigarettes that had been prepared to be smuggled out of the United States. The investigation resulted in the arrests and convictions of 12 people who were also involved in an illegal weapons and drug distribution organization associated with the Abu Sayyaf Group, a terrorist organization based in the Philippines.

This case exposed three main vulnerabilities in FTZ and CBWs. First, the lack of processing standards and associated due diligence. Ports operate differently and apply different standards. Some ports require that ship handlers must receive pre-approval in person with all relevant documentation prior to making deliveries. Other ports require that the delivery take place first and only then are some of the relevant forms supplied. The lack of a standard requirement exposes a vulnerability in the system.

Second, All transactions are initially conducted via paper and the entry into an automated system is not standard in all ports. This makes it easier to facilitate the diversion. Some ports input the movement of bonded merchandise, but other ports do not exposing the vulnerability of some ports.

The last vulnerability involves repackaging and smuggling within FTZs. Activities within zones are not closely monitored. Containers and shipments enter the zone and a company warehouse where repacking and labelling may take place as it does in this example. This provides a way to change the country of origin, company name, contents, quantity and price. Lack of oversight may also provide an opportunity to smuggle goods into or out of FTZs or CBW.

Case Study 4: Trade Based Money Laundering/Black Market Peso Exchange

The Kings Cross investigation, as it is called, demonstrates a connection between organized crime and transactions involving a company based in the Free Zone in Curacao. The investigators discovered a variant on the Black Market Peso Exchange in which the Curacao-based business operated as a currency exchanger for narcotics traffickers.

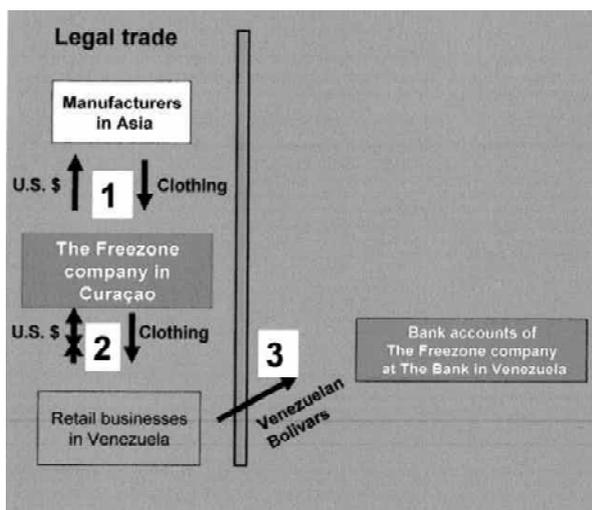
Step 1:

The Free Zone company was a clothing wholesaler that bought merchandise from Asia. The goods were shipped to the Free Zone in Curacao by container ship. The clothing was stored tax-free in the company's Free Zone warehouses. The terms of payment were in U.S. dollars.



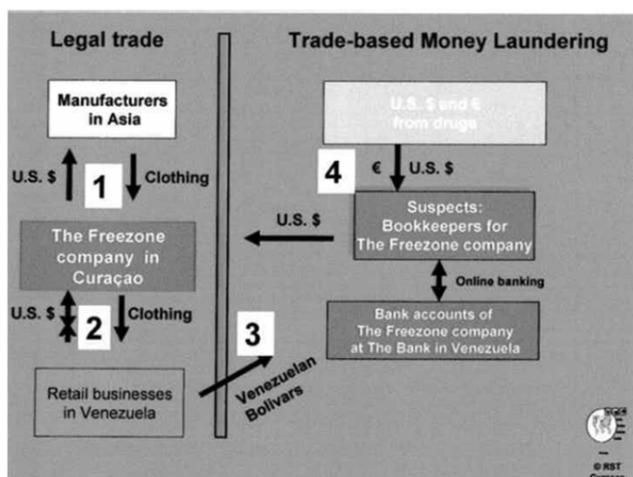
Step 2:

About 70% of the clothing is purchased by retail stores in Venezuela. Due to strict currency restrictions in Venezuela, retailers found it difficult to acquire U.S. dollars. Many companies including the one featured in this case study are forced to look for alternative means of payment.



Step 3:

The Free Zone-based clothing wholesaler agreed to accept payment in Venezuelan Bolivars to an account at a bank in Caracas. The Free Zone business opened three accounts in Caracas for this purpose in the names of three employees, including the bookkeeper. The employees in question obtained Venezuelan nationality for this purpose with little trouble. The accounts were managed online from Curacao.

**Step 4:**

The Free Zone company received the proceeds of illegal drug sales, millions of U.S. dollars and euros, in cash, which was deposited into the Free Zone company's bank accounts in Curacao. The company claimed the money was from the sale of clothing in Venezuela. The books for the Free Zone company did not include the bank accounts in Curacao. The Free Zone company bookkeepers also engaged in foreign exchange dealings by selling some of the cash to other companies.

The bookkeepers earned money through commission fees charged to customers and the Free Zone business was one of many businesses that purchased dollars from them. The Free Zone company exchanged Bolivars for dollars and drug cartels had the proceeds of narcotics sales converted into a clean currency.

The Kings Cross investigation resulted in 11 arrests, the confiscation of 3,500,000 Netherland Antilles Guilders and 1 billion Venezuelan Bolivars (approximately USD 500,000) as well as real estate and luxury cars.

This case demonstrates the use of a legitimate business as a money exchanger for narcotics traffickers. This business is acting as a financial institution for an illicit actor and by-passing relevant financial reporting requirements and regulations.

More information about the companies and company operations based in FTZs specifically, and in international trade more generally, would provide greater transparency.

In this case the zone demonstrated less supervision and the role of Customs and Inland Revenue was less due to the relatively small fiscal interest represented by the zone.

Case Study 5: International Wire Transfers/Use of Complex Corporate Structures and Schemes/Multiple Accounts and Transactions/Terrorist Financing

A key suspect in Euskadi Ta Askatasuna (ETA), a designated terrorist organization by Canada, the EU, the UK and the United States, was a shareholder of three companies set up in Spain. These legal entities supposedly sold computers and electronic equipment, but in reality they did not conduct any significant business. However, their bank accounts showed large cash deposits including large denomination Euro notes, and wire transfers.

Persons involved with these legal entities created companies in Costa Rica which were later transferred to Mr. U, owner and manager of company 'IT' a computer and electronics business based in a free trade zone in Costa Rica, which engaged in regular transactions with the legal entities in Spain. The bank was located in the free trade zone and AML/CFT obligations do extend to all financial institutions operating in the zone.

'IT' was supposedly in the business of importing computer parts, assembling and selling computers domestically and internationally. In practice, it had very little activity. However, within a six-month period IT received approximately € 3,400,000 in transfers from the legal entities in Spain and sent back almost the same amount. IT explained to the bank that the money was being sent from its parent group of companies in Spain to support its expansion in Costa Rica. Also, that the outgoing transfers were payments of imports from Spain.

The Costa Rican authorities believe that 'IT' was laundering the proceeds of illicit activity in exchange for a regular infusion of cash to continue day to day operations of the company. Although AML obligations did apply to the bank, the frequency of international transactions and the close proximity to customers may have resulted in relaxed oversight. Mr. U visited the bank on a daily basis and became personal friends with the bank manager and account executive associated with the account. As a result of this case, Costa Rican regulations now require banks to rotate employees of FTZ branches every three months.

Vulnerabilities associated with the FTZ:

Companies located in the zone are vulnerable to money laundering and terrorist financing. Although AML obligations extended to the bank, relaxed oversight of the institution permitted the activity to take place. Draft FIU regulations will require FTZ users to submit threshold-based reports to the FIU (cash and non-cash). The competent domestic authority that oversees FTZs would enforce this requirement.

At the time of this investigation terrorist financing was not a crime in Costa Rica (2008). This case facilitated the passage of legislation to make terrorist financing a crime.

Case Study 6: Customs Fraud

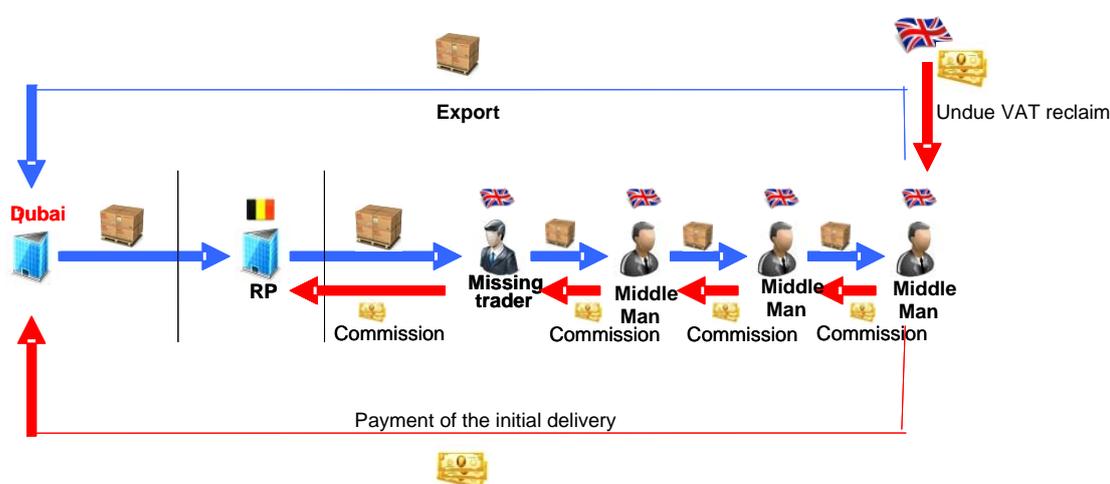
A particular Belgian company imported textile products and used textile-certificates (to prove the origin) from the United Arab Emirates (U.A.E.), which means that the goods were produced there or got a sufficient transformation there (depending on the type of finished product). The invoices and certificates came from 2 companies established in the Sharjah Airport Free Zone. It is very unlikely however that there would be production entities in this airport area. On the official site of this FTZ 16 production entities are not mentioned, only warehouses, offices, container parking areas. On the site is also mentioned that "the SAIF –Zone was built to promote and enhance business in an atmosphere free of regulations and red tape". This lack of regulations made it impossible for investigators to prove that the origin of the goods was not U.A.E. but another country from which import wouldn't have been possible in this particular case because import licenses were compulsory. Moreover the whole documentation and invoice circuit was seemed to be false so the commerce was especially vulnerable to abuse for money laundering purposes also.

This case demonstrates the use of fraudulent trade documents, in this case certificates of origin, to disguise the true origin of goods in order to evade duties and taxes and more generally facilitate/allow import/export trade. The vulnerabilities of zones are also showed as a result of relaxed oversight and enforcement as well as opaqueness of these areas.

This case also illustrates the challenges associated with discerning between customs fraud and Trade Based Money Laundering. This case does not indicate the transfer of value through the international trade system, rather the misuse of FTZs and the international trade system to perpetrate the predicate offense.

Case Study 7: Carousel Fraud¹⁷: “Dubai Connection”/Use of Corporate Structures/Trade Based Money Laundering

The Belgian company RP is involved in international VAT carousel fraud. It plays the role of “in and out” by purchasing properties in Dubai and invoicing British customers. The latter are “missing traders” to the detriment of British taxes. The invoice scheme in the United Kingdom involves various middlemen that get involved following the missing trader as well as an exporter that in the end sells the goods in Dubai and wants to reclaim the VAT from the UK Treasury (reclaim fraud). In the invoicing scheme every link assigns a payment order (consisting of a commission) to the following link. The goods are paid by the last link in the United Kingdom, directly to the initial supplier in Dubai. This last amount includes the British VAT. As such the amount of evaded tax is safely transferred to a bank account in Dubai and can be redistributed among the different organizers of this fraud.



The payment to the company in Dubai for the initial delivery is not made until the fraud cycle is complete in Europe. This case exposes the vulnerabilities associated with legal entities in the free trade zone, the open market created to promote trade and the challenge of tracking financial transactions related to business operating in the zones.

Case Study 8: Misuse of Legal Entities

This case resulted in the thorough analysis of financial flows existing between the head office of a Belgian society (in Belgium) and its subsidiary company located in a free zone of the United Arab Emirates (U.A.E.). Most of the information came from the penal file.

The company B used a foreign subsidiary company to remove the funds of the head office (advances on funds, needs for liquidities) and to transfer them to the subsidiary company in the U.A.E. These funds were also transferred to other free zones (Madera). The transfer of these funds via the U.A.E. made it possible for the company B to set up a real estate company for a precise real estate project in another European country. The analysis of the accounts in Belgium did not reveal the final destination of the funds and this company (“except perimeter of consolidation”) was unknown. This real estate project of great importance was carried out. Then, the actions of this company were sold and the benefit of this sale transferred to the subsidiary company in the UAE.

Part of these funds then returned to Belgium in the form of dividends and was deducted from the taxable amount (Advance Corporation Tax). The difficulties encountered in this case, can be generalized and result from:

¹⁷ FATF (2007).

- The legislation in the FTZ is not transparent.
- The absence of 'official' documentation about the FTZ¹⁸.
- No preventive conventions of double taxation at the time with the U.A.E. (Impossibility of obtaining an adequate collaboration).
- Use of false invoices to dissimulate the operation.
- Impossibility of checking the identity of certain recipients.
- Complication of the situation by using a cascade of free zones (Emirates, Madera).
- Problematic bank secrecy.
- Use of offshore companies

The detection of similar operations is almost impossible. In this particular case, the consultation of documents that were not part of the book keeping, seized by the Court, made it possible to give another interpretation of the accounting and revealed the offshore companies. The existence of subsidiary companies in FTZ, the deduction of the A.C.T on the level of the corporate tax, the existence of high value cash transactions in relation to (real estate) projects abroad constitute considerable ('red flag') risk indicators.

Case Study 9: Contraband Smuggling and Tax Evasion

This investigation involved a money laundering and contraband cigarette smuggling organization led by PAUL. The large-scale organization smuggled contraband cigarettes into the United States from China and subsequently structured cash deposits to avoid payment of millions of dollars in Washington State tax revenue. The cigarettes were imported into an FTZ located in Hawaii, then diverted to the state of Washington, rather than to the claimed destination, a Native American reservation in Idaho. PAUL then sold the illegally gained cigarettes in Washington, and laundered the proceeds.

As a result of the investigation 16 warrants were executed in Washington and in Hawaii, which yielded 1 451 697 million packs of contraband cigarettes, one vehicle and over USD 600 000. This seizure of the cigarettes reflects USD 2 068 668.20 in revenue loss to the State of Washington, the second largest such seizure in the history of the State. Paul and his associates were eventually indicted for smuggling and trafficking of cigarettes, money laundering, and structuring financial transactions.

¹⁸

Ex. information on the internet about U.A.E.: www.emiratesfreezone.com, www.uaefreezones.com.

CHAPTER 5: CONCLUSION AND POLICY CONSIDERATIONS

55. Free trade zones worldwide vary tremendously in order to provide different benefits to countries and regions. Although zones differ in terms of the activities and structure, there are fundamental similarities.

56. FTZs provide platforms for economic growth and are often the international commercial centre of a country combining a large port with infrastructure and a hub of growth and innovation. FTZs are often included in economic development plans for developing nations but are also seen as hubs of growth in the developed world. Zones continue to be developed and managed both publicly and privately and combine a wide range of administrative authorities which mix paper-based management with information technology. Modern zones have played a significant role in the global economy since the 1950s and they continue to develop and change to meet the demands of international business.

57. Globally, FTZs are designated geographic areas considered outside of the customs area. They offer duty and tax free access and often incorporate a number of other incentives for the businesses. Zones also combine a variety of administrative authorities, private and public, which can cause confusion and burden when it comes to oversight of the zone. The relevant competent domestic authorities operating in zones and their staff are often not prepared for the unique zone environment nor trained to ensure adequate enforcement of AML/CFT concerns. This can result in relaxed oversight and management in terms of shipments entering and exiting the zone as well as the intra-zone transfer of goods sold from business to business within the zone. Many zones also share the combination of paper and information technology-based record keeping for shipments and zone transaction which results in the lack of integration between the relevant zone authorities and Customs authorities. This can also result in relaxed oversight and enforcement.

58. The size and scope of zones world wide – over 3 000 zones throughout the world, many co-existing in cities and regions of significance to the international financial system – demonstrate the importance to the global economy on free trade zones. A jurisdiction operating without an FTZ within its borders is as susceptible today to the vulnerabilities posed by zones throughout the world. The world is connected through the international financial system and a vulnerability to one is a concern for all. As one vulnerability is closed, illicit actors move to areas with less regulation and oversight.

59. In today's global economy access to the financial system in any jurisdiction effectively enables access to the international financial system through the correspondent relationships and interconnectedness of the modern global financial system. Although this is widely recognized when it comes to our financial institutions and shared borders, this level of awareness has not yet been brought to the international trade system and more specifically free trade zones. While greater scrutiny has been paid to certain types of transaction others have yet to fully address the relevance and importance of FTZs.

General key findings related to all Free Trade Zones:

60. There is tremendous variance in the oversight and management of zones worldwide which, along with a wide variety of zone activity from manufacturing to retail operations, make standard setting a clear challenge.

61. Case studies identified a variety of methods used to move and launder the proceeds of crime. They reflect links between FTZs, cash transactions, smuggling, VAT carousel fraud schemes, shell companies, and TBML.

62. It is necessary to balance the economic benefits of FTZs including foreign direct investment and job creation, particularly in developing countries, with ML/TF vulnerabilities.

63. The lack of integrated IT systems in the zones to monitor transactions and movement of goods in the zones on a timely basis is a principal vulnerability.

Key findings related to existing FATF standards:

64. The adoption and enforcement of AML/CFT regulations in the zones is an area which needs to be further clarified and addressed.

65. Often the nature of business within zones appears to be based on cash transactions. (*e.g.* R. 19, SR. IX)

66. The lack of transparency of businesses operating in zones is a vulnerability which is related to FTZ supervision as well as financial or commercial transactions taking place in these zones. It is clear that specific ML/TF risks of these zones are not considered. (*e.g.* R. 5, 33)

67. The lack of international cooperation between competent authorities and law enforcement including Financial Intelligence Units within FTZs was highlighted by a number of case studies complicating the fight against fraud and the laundering of money channelled through these zones. (*e.g.* R. 36 – 40)

Key findings not related to existing FATF standards:

68. Trade Based Money Laundering is a prevalent method used demonstrating that TBML is a substantial vulnerability in FTZs. (*e.g.* see Best Practices Paper on TBML)

69. The misuse of Free Trade Zones impacts every jurisdiction in the world, regardless of whether or not a country has FTZs. In order to effectively address the ML/TF vulnerabilities there must be a global approach to the solution.

Issues for Consideration

70. This report highlights the money laundering and terrorist financing threats and vulnerabilities of free trade zones based primarily on law enforcement findings through case studies. Based on the elements presented in this report, the following issues are recommended for further consideration:

71. The issue of FTZs should be examined in the light of the current FATF 40+9 Recommendations.

72. Awareness raising should be conducted to the private sector and relevant competent authorities, namely FTZ administrators and Customs authorities, FIUs and bank regulators to better identify the cases of FTZs misuses by criminals. The need for a stronger focus on training programs is crucial and will raise awareness about the potential misuse of FTZs.

73. There is a clear need to improve the cooperation between competent authorities at the national and international level as well as with the private sector as it relates to FTZs. The exchange of information is a key element to better identify the illicit activities (*e.g.* fraud schemes) using FTZs.

74. Greater consideration should be given to increasing transparency, regulations and effective controls by appropriate procedures which must be apply in all FTZs. In that context, further consideration should be given to the existing best practices listed by the report in Annex B and the elements from the key findings.

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ANNEX A: ML/TF RISK INDICATORS

Through the questionnaire and case studies the following red flag indicators for illicit activity in free trade zones were collated.

Red flag indicators associated with financial institutions:

- The method of payment requested by the client appears inconsistent with the risk characteristics of the transaction.
- The transaction involves the receipt of cash (or other payment methods) from third party entities that have no apparent connection with the transaction.
- The transaction involves the use of repeatedly amended or frequently extended letters of credit.
- Wire instructions or payment from or due to parties not identified on the original letter of credit or other documentation.
- Deposits of large amounts of cash US\$ or Euro's, without sufficient understanding or explanation of the underlying transaction.
- Banks lack specific knowledge on understanding of the FTZ business.
- Entity is a company with low capitalisation but it carries out a high number of daily transactions that are disproportionate to its capitalisation.
- Entity has large sums deposited and immediately remitted out regularly.
- Use of fiduciary companies established in FTZ.

Red flag indicators associated with unusual business activity:

- The commodity is transhipped through one or more jurisdictions for no apparent economic reason.
- Circuitous route of shipment and/or circuitous route of financial transaction.
- Transaction involves shipment of goods inconsistent with normal geographic trade patterns *e.g.* does the country involved normally export/import goods involved?

As part of the questionnaire, jurisdictions were asked specifically what could trigger suspicions or possible investigations. Nine jurisdictions provided potential risk indicator including:

Red flag indicators traditionally associated with TBML: under/over invoicing, multiple invoicing of goods and services, over and under shipment and falsely described goods and services.)

- Significant discrepancies appear between the description of the commodity and the actual goods shipped.
- Significant discrepancies appear between the value of the commodity reported on the invoice and the commodities fair market value.
- The size of the shipment appears inconsistent with the scale of the exporter or importer's regular business activities.
- The type of commodity being shipped appears inconsistent with the exporter or importer's regular business activities.
- Inconsistencies in information contained in trade documents and financial flows, such as names, companies, addresses, final destination etc.
- Declared value of shipment was under-valued compared to the shipping cost.
- Transaction demonstrates links between representatives of companies exchanging goods *i.e.* same owners or management.
- Container shipments being consigned and exported and imported a number of times. An example of this would be the same goods being recycled.
- Transaction involves shipment of goods incompatible with the technical level of the country to which it is being shipped *e.g.* semiconductor manufacturing equipment being shipped to a country that has no electronics industry.
- Order for the goods is placed by firms or individuals from foreign countries other than the country of the stated end-user;
- A freight forwarding firm is listed as the product's final destination.
- Traded goods that are in transit to localities close to the borders.
- Goods that are easily used in bartering schemes (cigars, gasoline, tires, etc) traded to localities close to the borders.
- Direct financing from importer can be associated to international trade frauds and TBML.
- Entity has little or no inventory carried on its premises on inspection or field intelligence.
- A typical transaction in sectors with heavy competition and sensitive to fraud (computers, cars, phone, petrol products, textile, electronics).
- Types of products are more susceptible to ML, such as precious stones and metals, tobacco products, artwork, etc. and should be more closely monitored.
- In the case of services: verification if an invoiced service was actually performed.

Risk indicators associated with shell companies

- The transaction involves the use of front (or shell) companies.
- Overinvoiced exports involving tax haven jurisdictions.
- Using a company with its registered office in a tax haven or an offshore centre carrying out atypical transactions (example: loan to a Dubai company to finance commercial domestic activities in Belgium).
- Entity's only known premises are those of a corporate service provider (*i.e.* likely to be a shell company).
- Intervention of third parties (front men).

ANNEX B: COMPILATION OF BEST PRACTICES AND RECOMMENDATIONS

Based on experience, a number of organizations and jurisdictions have developed best practice and reference tools for the administration and regulation of FTZs and how best to address Trade Based Money Laundering (TBML). Examples from the CFATF, the FATF, Aruba and the WCO should serve as a basis for future work. A number of the recommendations noted in this annex are complimentary to that of others and therefore some unavoidable duplication exists.

1. Caribbean Financial Action Task Force Guidelines.
2. Multilateral Recommendations on Black Market Peso Exchange.
3. FATF Guidance on TBML.
4. Aruba's experience.
5. World Customs Organization instruments and Standards.

1. Caribbean Financial Action Task Force Guidelines¹⁹

The Caribbean Financial Action Task Force (CFATF) first began to look at the money laundering and terrorist financing vulnerability of FTZs in 2000. Members of the CFATF developed recommendations and in 2001 recommended that the governments of the CFATF members implement the following:

Devise, enact, and effectively implement a comprehensive legislative regime affecting Free Trade Zones. The legislative regime must clearly and unequivocally define the term "Free Trade Zone" and must govern all areas of its operations. Areas of Free Trade Zone operations to be governed include, but are not limited to: the granting and revocation of licenses to operate a business therein; record keeping and reporting requirements for these businesses; and, establishing and defining the oversight and supervisory authority, functions, responsibilities, and powers of the Free Trade Zone Authority. Where necessary, such a legislative regime should meet the following requirements:

The Free Trade Zone Authority, if necessary, should be physically present and operate in the Free Trade Zone. The appropriate National authorities should, at minimum, oversee and supervise all operations in the Free Trade Zone and enforce sanction violations of all applicable laws and regulations.

Businesses operating in Free Trade Zones must comply with all applicable laws and regulations and must establish an anti-money laundering compliance program which includes an independent review and internal audits. It is strongly recommended that businesses designate a compliance officer who shall be responsible for monitoring and ensuring implementation of the compliance program.

¹⁹ Caribbean Financial Action Task Force (2001).

Businesses operating in Free Trade Zones should be required to identify their clients and to keep the record of each transaction and to report suspicious activities to the competent authorities.

Free Trade Zone Businesses should be required to report suspicious transactions to the competent authority in the form and manner that the authority directs. Additionally, it may be required that all businesses operating in Free Trade Zones should report to the competent authority all transactions in cash or negotiable bearer instruments exceeding USD 10 000.00 or its equivalent in other currency, or postal or other money orders, travellers checks and third party checks.

Governments should discourage businesses operating in Free Trade Zones from accepting cash payments, or payments in money orders or third party checks, traveller's checks, wire transfers, or other means from parties that are not directly related, as either the seller or buyer, to the underlying transaction. These businesses should, at a minimum, record such transactions and, when determined as suspicious report such transactions to the competent authorities.

Require competent Authorities to make available to regulated businesses current copies of all applicable laws, administrative resolutions, regulations, advisories and directives regarding: the conduct of business in the Free Trade Zone; compliance with all applicable legal requirements; and, advisories regarding suspicious activity and recommended countermeasures.

Require competent Authorities to designate, as part of their core operation, a specialized unit responsible for all matters dealing with the prevention of money laundering and to carry out ongoing related training for businesses operating in the Free Trade Zone. This unit should, at a minimum, produce an instruction manual detailing the powers vested in the Authority, the obligations of businesses operating in the Free Trade Zone, and the internal anti-money laundering mechanisms, including all reporting and record keeping requirements, which must be maintained by these businesses.

Devise and implement all necessary measures to establish and promote coordination between the administrative and all other authorities involved in the prevention, investigation, and prosecution of money laundering activities.

Take affirmative measures to ensure uniformity in data collection practices affecting international commerce and enact measures to ensure that the data collected related to international commerce is available to other governments in accordance with applicable law.

2. Multilateral Recommendations on Black Market Peso Exchange

The Black Market Peso Exchange System Multilateral Experts Working Group²⁰ issued a statement signed on March 14, 2002, describing the methodology, conclusions and made recommendations, which can be deemed as 'Best practices'.

Conclusions

The Experts Working Group concluded that:

- TBML occurring in the region, which facilitates narcotics trafficking, terrorism and other crimes, poses a serious threat to the financial systems, and economic stability of the region.

²⁰

The BMPE MEWG consisted of the United States, Panama, Venezuela, Colombia and Aruba.

- More financial and personnel resources should be assigned to the development of a concerted and coordinated attack on TBML.
- Non-existent or incompatible trade data reporting systems make the effective tracking and monitoring of imports, exports and transshipments difficult.
- The absence of adequate registration and regulation of merchants engaged in international commerce and the lack of screening procedures for those merchants operating from a special customs and/or tax areas, such as FTZs, can contribute to the proliferation of TBML.
- The scope and magnitude of TBML could be reduced by the development and implementation of education and outreach programs.

Recommendations²¹

Short term

Conduct Public Outreach Programs for manufacturers, other persons engaged in international commerce, as well as Free Trade Zone Operators and merchants to:

- Educate them on the methods used to conduct trade-based money laundering.
- Provide them on a continuing basis with information regarding trends and patterns of trade-based money laundering and related suspicious or unusual transactions.
- Engage them in government-private enterprise coalition to combat trade-based money laundering.
- Encourage them to develop and implement their anti-money laundering programs and procedures effectively, including enhanced customer identification systems.
- Engage them in the development of a 'Code of Ethics' for free trade Zones and related areas aimed at preventing money laundering and other illegal activities.
- Educate them on legal requirements for the conduct of legitimate international commerce.
- Inform them through government publications in printed media as well as on internet explaining the risks of involvement in a money laundering operation and providing relevant laws, procedures, controls and legal practices, as well as 'best practice' guidelines for cross-border transactions. Such information should emphasize the requirements related to payment of applicable duties and taxes, including import and export licenses, where applicable, as well as outline all authorized payment procedures.
- Inform them, in particular, through these same publications and the appropriate websites, about legally prescribed payment procedures.

²¹ Edited from the original version, some BMPE recommendations are now covered by FATF recommendations.

Adequately screen, register and regulate merchants engaged in international trade, including Free trade Zone Operators, in order to ensure that they do not contribute to the proliferation of TBML.

Improve communication, coordination and cooperation among the various law enforcement, regulatory and supervisory agencies to include customs, tax and bank regulatory agencies.

Publicize the administrative and criminal penalties applicable to pertinent violations.

Long Term

Improve the collection, quality and international exchange of trade data for the purpose of developing a regional Numerically Integrated Profiling System (NIPS) to help promote legitimate trade by developing a more accurate picture of trade flows and focus law enforcement and regulatory resources to better identify and combat criminal activity.

Conduct economic, social, political and/or legal studies of the problem of TBML, focusing on issues such as the international exchange of information, the control of borders, the regulation of persons engaged in international commerce, the regulation of FTZs and other zones of international commerce, and, based on the results of such studies, propose solutions to address major problems.

Develop and implement the money laundering prevention guidelines for the CFATF Member Governments, Merchants, and FTZ Authorities as a general framework for effectively detecting, preventing, investigating and prosecuting TBML cases.

Consider bilateral or multilateral agreements or arrangements to fill existing gaps with regard to the exchange of evidence and information and facilitate the investigation and prosecution of those responsible for perpetrating the crime of money laundering.

Provide adequate funds, training, personnel, and systems, necessary for the effective detection, prevention, and prosecution of ML cases. Identify experts in each jurisdiction for the investigation and prosecution of TBML cases and focus the training to be offered nationally and internationally accordingly.

Make efforts to allocate a certain amount of each government national budget to ML prevention projects and consider offering international AML assistance to jurisdictions that require it.

Continue efforts to inform banking and non-banking financial institutions and merchants of activities, trends, methods in ML and suspicious transactions, and resources permitting, offer necessary training.

Establish, where necessary, trade data reporting systems to make possible the effective tracking and monitoring of imports, exports, and transshipments.

Encourage the establishment of a regional program for the exchange of information on shipping departures. This information system should operate online and in real time and include information on the shipper, type of cargo, destination and means of transport.

Encourage the development and implementation of an electronic customs filing and reporting system with universally compatible data fields that can be used to track the flow of goods being imported, imported, or transhipped from, to, or through each of the jurisdictions FTZs.

License, regulate and monitor entities and individuals acting as customs brokers, and persons operating bonded warehouses to promote compliance with applicable rules and regulations. Non-compliance should

be sanctioned and, in appropriate cases, such sanctions should be on the public record and/or lead to the revocation of the license.

Chart all FTZs and special customs zones in their jurisdictions and make this information publicly available.

Evaluate their jurisdictions AML legislative framework and their effectiveness in combating TBML.

Develop and implement a system to identify, and make available to all FTZ authorities, the names of FTZ merchants and users whose operational permits have been terminated as a result of ML activity.

Seek international cooperation to strengthen border security and checks to prevent TBML.

3. FATF Guidance on TBML

The Financial Action Task Force published a typologies report on TBML in June 2006. This report defined the term trade based money laundering and identified a number of case studies to illustrate the money laundering vulnerability. In 2008, the FATF published a Best Practices Paper²² which is based on six principles relating to TBML which are:

- a) In order to raise awareness and build expertise to combat TBML, countries should agree to incorporate TBML into existing training programs on AML/CFT. Such programs should include training to relevant law enforcement agencies concerning existence and relevance of financial and trade data to crime targeting.
- b) Countries should agree to make case studies and red flag indicators identified in the typologies report available to competent authorities and financial institutions.
- c) In order to ensure that the expertise of competent authorities includes a focus on combating TBML, jurisdictions should develop a domestic mechanism to link the work of authorities responsible for collecting, analysing and storing trade data with authorities responsible for investigating money laundering and terrorism financing.
- d) The collection and exchange of trade data shall only be conducted in an authorised manner and consistent with jurisdiction's domestic privacy and data protection laws.
- e) In order to facilitate international cooperation in combating TBML, countries should establish clear and effective gateways, subject to appropriate controls and safeguards, to facilitate the prompt and effective exchange of trade data and other relevant information among authorized counterparts.
- f) The above measures should be implemented with a view to ensuring that legitimate trading activities are not unreasonably hindered or obstructed.

4. Aruba's Experience

In the mid 1990's Aruba's free trade zone was heading towards being more a liability to economic development than a benefit. There was a multitude of international bad press, with allegations ranging from

²² FATF (2008).

mafia presence and money laundering to smuggling. In some countries they were put on a black list. Several businessmen with businesses in the free trade zone were extradited to the US to face money laundering charges. This all took place before there was a formal definition for trade based money laundering.

During this same period, the extreme dependence on tourism as the single most important economic pillar led the Aruban Government to decide to diversify the economy, and the free trade zone offered potential. However, for this to be feasible, the free trade zone needed to improve its image. The threat of the bad press to tourism was even such that it was either Clean Up or Close Down.

In response to the situation, the Governments of Aruba and the Netherlands decided to research the vulnerabilities of certain aspects of the economy, of which the free trade zone was one, and make recommendations to improve their functioning and ensure integrity.

Free trade zone businesses are per definition mobile, they are not dependent on a local market and look for the best location based on different criteria, such as tax incentives, proximity to international customers, security, quality of banking and business support services, availability of labour, etc. Aruba has introduced integrity into its marketing approach, and the experience shows that integrity in itself is a valuable magnet for legitimate businesses.

To protect FTZs from being used for illegal activities, such as money laundering, underground banking and smuggling, the guiding principle in this journey has been *prevention*: how to raise the threshold, make it more difficult to launder illegal proceeds, and protect the integrity of the trade system. The development of a program based on promoting integrity, prevention, transparency and risk assessment is a best practice. As experience has taught, law enforcement and prosecution are not the ideal first line of defence.

The purpose was to identify a general framework within which to solve the problems and address the vulnerabilities that were identified. The main issues were adequate control, transparency and a risk-based approach.

Law and management

Two general changes were made to solve the problems. First, to further implement the lessons learned, new legislation was adopted, updating and strengthening the rules and regulations. Secondly, management of operations and development of the free trade zone was privatized, by means of granting an operating concession to Free Zone Aruba (FZA) NV, a limited liability company 100% owned by the government. FZA has exclusive rights to manage all free trade zones on Aruba.

A crucial element in the journey was the fact that all existing free trade zone companies wishing to continue operating from the free trade zone were re-admitted under the new rules and regulations. The new rules and regulations immediately proved their preventive effect; some companies chose not to even try to be re-admitted.

Admissions

Before a company can be admitted to the free trade zone, FZA must conduct its own due diligence and get to know the client. The due diligence is mainly done through a pre-admission screening consisting of background checks, a business plan and a source of funds declaration.

The zone authority requires transparency of the company structure: who is/are the ultimate beneficiaries? The background checks are done on all shareholders, directors and persons with a relevant power-of-attorney. Furthermore, the potential clients must submit a business plan detailing the intended type of

business: what type of goods, services; between which countries; information on clients. It helps us define a client profile needed for the risk-based approach. Also, the client must sign a statement declaring the source of funds which will be used to start up operations and that fact that these funds do not originate from criminal activity.

If and when the due diligence is completed, the client can be admitted to the free trade zone. The admissions documents consist of an operating license granted by the operator; among other things it describes the approved business activities. Also, a contract is signed between the operator and the free trade zone company, which can be adapted to suit different kinds of businesses, as the situation demands.

The admissions contract includes an Operations Manual, containing detailed descriptions for required transparency in business operations, KYC requirements, acceptable methods of payment, bookkeeping requirements and the additional elements that must be included in the yearly audited accounts, such as the receipt of cash payments.

An important general requirement is that companies have a physical presence in the free trade zone with persons on the island with sufficient power-of-attorney. The administration must be kept on Aruba. This prevents PO Box companies and promotes control and transparency.

Control and sanctions

During the operational phase FZA has the obligation and the right to check on any aspect of the business operations. In general, requested documents must be made available within 24 hours. If the admissions requirements are not being met, depending on the severity, various sanctions can be applied. Business operations can be halted and the license can even be revoked retroactively, with hefty financial consequences regarding taxation.

It is a misconception to perceive the Free Zone Aruba (FZA) NV took over complete supervision of the free trade zone. These new requirements are in addition to any rules and regulations applied by Customs, the Tax Department, commercial banks, etc.

Admission procedure

The background checks are an effective mechanism, however the reliability and timeliness of the information varies among the countries that the clients originate from. From a business perspective clients can be admitted before completing the background check, however if the result is positive, *i.e.* there are grounds on the basis of which the company should not have been admitted, the license will be revoked retroactively.

The business plan is an excellent way to gain insight into the clients' intended activities and create a client profile on the basis of which controls can be conducted. However, many entrepreneurs don't yet have detailed information; they will start a business and see how it grows. This issue is partly solved by limiting the amount of business activities stated in the license to those actually being conducted. This assists in monitoring the business activities. If the company wishes to expand their operations at any given time, they submit a written motivated request to broaden the license, which is usually granted. In the case of expanding to 'sensitive' business, such as the trade in second-hand cars from Colombia, we can impose extra rules.

A great deal has been learned about clients by simply conducting simple internet searches. Potential clients are required to give information concerning other companies they have an interest in. These companies sometimes pop up in unexpected ways. Also, once the name of a potential client came back as a convicted money launderer. In any case, it helps to ask the right questions.

Some clients, for many different reasons, never complete the admissions procedure. It seems to work as a threshold for businesses that can't or don't want to maintain transparency into their intended business operations.

Payment methods

The transparency between goods and payments has improved substantially. There are still cases of third party payments, but the reason for this is on file. Some companies call the authorities before accepting a payment, and have joined these in the learning curve.

Cash U.S. dollars are still used as payment, although less often than before the new system, and are usually brought in by the Colombian/Venezuelan boat captain that will transport the goods out of Aruba. However, there is now a reporting requirement for cash being brought into the country, which goes to the FIU, and the client may not accept these cash payments without a copy of the reporting document (which is included in the transaction file). Cash payments above a certain limit must also be reported to Free Zone Aruba (FZA) NV.

In many cases the clients of free trade zone companies have a standing current account. If these accounts are not balanced on a regular basis, which constitutes a 'red' flag, there is no insight into the payment of specific invoices and underground banking may be occurring.

The reporting procedures and internal procedures used by banks are very important to complement and complete the system. It is imperative that they have a deeper understanding of their clients' business, in this case international trade, to sufficiently protect themselves.

Shift in trade

In some cases there has been a shift in trade from the free trade zone to the 'unregulated' interior. It could be a flight from oversight, or it could be a financial decision because the goods themselves aren't subject to import duties (the free trade zone then becomes more expensive alternative to operating from the local market).

We have also seen a substantial shift of trade from Aruba to other countries.

Location challenges

Free trade zone clients are required to gather and confirm certain types of information from their clients, such as company registration and personal ID's, as part of the KYC procedure. Historically, Aruba has always done a great deal of business with Colombia and Venezuela, due to the vicinity. In some cases, clients from the aforementioned countries are not willing to give this information, we assume for tax purposes.

Goods leaving Aruba destined for these two countries are often transported by very small cargo boats, owned and operated by the captain. The goods are shipped FOB. It is not known if the goods are actually transported to the places stated on the Customs documents. Aruba regularly receives visits from Colombian Customs officials trying to crack down on smuggling into Colombia, only to find out that the goods leave Aruba in a completely legal manner.

Ultimate beneficiary

Sometimes it is a challenge to gain insight into the company ownership structure. Free trade zone companies may only have registered shares. However, in one instance these shares are owned by a

company in Panama that issued bearer shares. A declaration was requested concerning the owners of these shares and this information was on file, but it's not an ideal situation. Sometimes, for example for tax purposes, the structure is quite complicated and it's not sure how far up it's needed to go. There is no international standard.

Services

Services, one of the fastest growing types of business conducted through the free trade zone, pose a different challenge, that of intangible goods. In the case of indent trade, whereby the goods are shipped straight from A to B, without reaching Aruba, Customs documentation was required from country A and B substantiating that goods were actually shipped, and fit with the payments.

Supervision and control cannot replace law enforcement, but they are an effective line of first defence. Prevention is a substantial component in combating illegal activities. It is at least heartening to see how many of the challenges were overcome simply by conducting regular checks at the various companies

With limited resources it is wise to adopt a risk-based approach, this also disrupts legitimate business the least. Every type of business poses a learning opportunity for operators, and the businesses themselves have also learned over the years. Sometimes this is not an easy, speedy or inexpensive undertaking. There are costs involved in changing systems. And change does not come as quickly as it would be.

Based on these experiences the process is to rewrite the Operations Manual. The changes do not lessen the good business practices it promotes, but change the requirements to impede normal business less. When introducing the system the bar was set at the highest level, and can now be lower where possible.

Prosecution of suspected money laundering cases through the free trade zone has been difficult. The current legislation is being amended to solve certain problems. Often, the public prosecutor for various reasons focuses on other crimes, such as tax evasion.

Keys to success

On an international level combating TBML is still in the infant stage. We are in the process of gaining insight and developing systems. The specific vulnerabilities of FTZs create a challenge. On a local level the situation is of course no better. This situation is compounded by a lack of local expertise to conduct financial investigations.

The introduction of new reporting requirements and adding new groups that are required to report, the general lack of budgets and sufficient personnel have overloaded the AML system. Introducing international trade into the system will only make it worse.

Even when there is a suspicion of illegal activities there is often the problem exchanging information. There are confidentiality requirements, unclear or insufficient mandates and a lack of analytical tools to facilitate any research.

There are no specific reporting requirements in place for international trade, and developing these reporting standards is not easy. In the financial sector there are more clear-cut situations and objective indicators. In the case of international trade it can be the type of goods, the payment methods, the country of origin or destination, etc. Even the time of year a transaction takes place could trigger a report.

All these issues are not unique to Aruba and only serve to underline the need to develop international systems and standards.

An effective system will have to deal with real vulnerabilities. To identify these more research is needed. After identifying concrete measures that need to be taken, a system needs to be set up whereby institutions have sufficient knowledge and the tools to work together.

Education and training is critical, and must involve all concerned with international trade and the vulnerabilities, from the private sector all the way through the judicial system. Each institution has a unique perspective and generates information.

Besides the national first level of defence, international cooperation needs to be improved. The exchange of information, such as trade statistics, is crucial.

A more global and international approach, even if a country does not have a FTZ, is needed. A more balanced approach to international standards *i.e.* that prevention, good business practices, law enforcement, etc. must be included.

To develop an effective system that cannot be ignored it's crucial to focus on the bigger picture and look for the global similarities, not the regional differences.

It is important to promote integrity as a marketing tool and address the economic concerns of regulating FTZs.

Challenges

Challenge 1: Balance the development of trade and the economy with the control of FTZs and the integration of an AML/CFT regime.

It is important for Customs Administrations not only to have the right to control, but also to exercise that right by devising appropriate control regimes and carrying them out on a systematic basis, bearing in mind the original purpose of the Free Zone is to promote legitimate trade. With this original aim in mind, there is even greater justification for Customs Administrations to exercise well-constructed proportionate controls, in order to ensure that legitimate trade is facilitated and to root-out and frustrate illegal trade that is in violation of national prohibitions and restrictions, such as those breaking the IPR legislation. From anecdotal evidence provided by right holders and from the knowledge based on IPR seizures, it is known that quite often free zones have been used to hide the true origin of the goods and have also been exploited to produce and/or distribute counterfeit and pirated goods. It is therefore of great importance that Customs exercise the powers given to them in national legislation.

Historically the creation of FTZs was intended to promote the economic development for specific areas by various incentives which can be tax exemptions or trade facilities. The new concern to better control these zones in relation to the fight against fraud and money laundering could be counterproductive in terms of economic and trade impact. There is therefore a difficult choice to manage and balance the two challenges.

Challenge 2: Global approach at the international level and implementation of a strategy worldwide and by all jurisdictions.

Obstruction of opportunities for criminals to launder their money and especially drug dollars is identified as an important strategy. Countries are put under a lot of pressure to implement this strategy. Trade partners are also concerned about the international assistance and cooperation to increase the effectiveness

of the anti-money laundering initiatives. So too, the feeder countries are identified²³ as trade partners and are put under pressure to bring about changes in their trade compliance systems.

If it's not the case, the FTZ which is regulated will lose clients and volume of the business in favour of other FTZs which are not regulated because of the cost benefit analysis. The implementation and compliance with the new rules may be costly which is not an investment for the others FTZs and this situation has an impact of the competitive aspect of the issue.

Challenge 3: Integrity has a price and generates a cost which can have consequences on volume of business in zones in terms of competitiveness. Existence of double standard.

Integrity as a model can become an 'integrity doesn't pay' conviction. The invested funds in the integrity policy implementation had to be taken out of other budgets: education, health care, infrastructure. These decisions were made based on the premise that integrity would pay off but have now lead to the conclusion that a double loss has been suffered.

The competitive advantage of non-compliance needs to be dealt with, a level playing field needs to be guaranteed. Examples from the process of regulating the financial sector are obvious, there was shift from regulated to the unregulated jurisdictions. From an economic perspective it can be an advantage to postpone implementing the rules and regulations for as long as possible.

5. World Customs Organization Instruments and Standards

Customs worldwide has to develop policies and procedures which must consider the needs of legitimate traders for trade facilitation while at the same ensuring that the economy and security of nations is protected. In this regard, the WCO has developed two major instruments – the International Convention for the Simplification and Harmonization of Customs Procedures (known as the Revised Kyoto Convention) and the Framework of Standards to Secure and Facilitate Global Trade (known as the SAFE Framework of Standards).

The Revised Kyoto Convention is considered the blueprint for trade facilitation. It contains legally binding standards covering the core activities of Customs. The Convention reflects the main principles of transparency and predictability in Customs matters: standardization and simplification of documentation; simplified procedures for authorized persons; maximum use of ICT and international standards, minimum necessary controls to ensure compliance with customs laws; use of risk management; use of audit based controls, co-ordinated interventions with customs and others border agencies; use of pre-arrival information which in aim leads to pre-arrival customs processing and quick release times, and partnership with the trade. This convention contains standards and recommended practices that are particularly applicable to the operation of free zones.

The SAFE Framework of standards will revolutionize the operation of customs to meet the challenges of the 21th Century and vastly improve its ability to secure and facilitate global trade. It was developed by the WCO and its MS in close consultation with international organizations and the world's business community. Implementation of the Framework will contribute positively to economic and social development, act as a deterrent to international terrorism, secure revenue collections and promote trade facilitation world-wide. The SAFE framework aims to establish standards that provide supply chain security and facilitation to goods being traded internationally, enable integrated supply chain management

²³ In this model I will just illustrate the effects and reactions of the feeder countries. In practice an entire chain of links are influenced, all the way 'up the chain' to the suppliers and beyond.

for all modes of transport, enhance the capabilities of customs administrations, strengthen networking arrangements between customs and business communities; and champion the seamless movement of goods through secure international trade supply chain. It also provides for advance provision of data, the use of risk management and the use of non-intrusive inspection technologies.

Arising from the joint forum World Free Zone Convention (WFZC) believes that its network will be looking at ways to strengthen their cooperation with customs and to eradicate customs-fraud; at the potential for member state accession to the Revised Kyoto Convention (1); and at the possibility of becoming Authorized Economic Operators (AEO) is envisaged in the WCO Safe Framework of Standards (2).

The WCO has developed a number of standards, procedures and tools to address security concerns related to the international supply chain.

Specific Annex D2 of the Revised Kyoto Convention stipulates Customs procedures and practices for the establishment and control of free zones in a simplified and harmonized manner. At the same time, it provides for the needs for controls: "*Customs shall have the right to carry out checks at any time of the goods stored in a free zone.*" (Standard 4)

The number of Contracting Parties accepting Specific Annex D2 is at 9 out of 64 as of 1 October 2009. The Contracting Parties, who have introduced the free zone system within their territories and have not accepted Specific Annex D2 are encouraged to study the possibility of acceptance of this Specific Annex and/or, if not possible to accept immediately, to act upon the Standards and Recommended Practices contained in the Specific Annex from a viewpoint of maintaining appropriate levels of Customs control.

Members of non-Contracting Parties to the Revised Kyoto Convention are equally encouraged to examine the possibility of ratifying the Convention or taking appropriate Customs control measures in line with the Convention. For this purpose, the WCO Secretariat is going to commit itself to promoting wider accession and application of the Revised Kyoto Convention by Member administrations

In cases where is not the Customs but other agencies in charge of controls over free zones goods and operations, Member administrations are encouraged to contact them to explain the need to take control on behalf of Customs. Customs in such countries should have the capacity to monitor the quality of controls of such agencies.

It is well recognized that tax and duty evasion is not only the Customs offence for which free zones are exploited. In fact, the Customs Enforcement Network / CEN database shows a number of fraud cases related to illicit trade in counterfeit goods, cigarettes and tobacco products. The WCO's annual reports on drugs, tobacco and counterfeit goods specifically highlight the problem that free zones are exploited by organized criminal syndicates by means of disguising countries of origin of consignments, thus attempting to avoid being targeted for Customs physical checks.

Given the fact that significant volumes of counterfeit and pirated goods have been stored, re-labelled, re-packed or even manufactured within the free zones, the WCO Secretariat prepared Guidelines on controlling free zones. Member administrations are urged to compare current enforcement practices and the Guideline best practices, and take appropriate action within their competencies. Due attention should be paid to possible discrepancies in the definition and legal establishment of free zones from that provided in Specific Annex D2 of the Revised Kyoto Convention.

Absence of controls over the goods and economic operations carried out in free zones poses potential risks in terms of security of the international supply chain. In the current social and economic environment,

where security issues are of paramount importance, such risks should not be left unaddressed. Since the free zone system has been integrated as an integral part of the trade policy of many WCO Member countries/territories, an appropriate risk assessment should be urgently. It is believed that risk assessment would lead to the improvement of compliance and reduce the potential risk of being exploited for commercial fraud purposes.

At the same time, Members should pay due attention to the "World Customs Organization Message Concerning the World Free Zone Convention (WFZC) Forum". A major outcome of the forum was the WFZC's agreement to continue to cooperate with Customs and the WCO in the fight against terrorism and Customs fraud in all its forms. Accordingly, Member administrations are highly encouraged to initiate partnership dialogues with those participating free zone management authorities at the national level in the interest of ensuring economic protection and security.

In order to accurately target high-risk consignments for control, it is essential to share information and intelligence on commercial fraud among Members for the purpose of analyzing the trends and nature of the commercial fraud cases involving exploitation of specific free zones. Information exchange with the Member administrations where the exploited free zones are located is critical. In this context, Member administrations are encouraged to feed seizure data into the WCO CEN database in a timely manner and appropriately indicate the exploitation of free zones, if this is the case.

At the same time, WCO Members are asked to provide narrative information on significant cases to the Regional Intelligence Liaison Offices (RILO) and the Secretariat for sharing relevant information on the cases and investigative leads which may be included in the Commercial Fraud Typology Summary.

Application of risk indicators for identifying anomalies in filed import declarations is highly encouraged.

Introduction of free zone systems are decided from a country's economic/industrial policy viewpoint. Aggressive Customs intervention may affect the current national policies on free zones and may bring about controversial political and/or legal debates as to whether the existing free zones have extraterritoriality concerning Customs control. Having said that, Customs may not be able to exercise sufficient control authority under the existing free zone system. Members should be aware of potential risk for exploitation from organized crime organizations as well as terrorists.

From the Customs enforcement perspective, applying essential means of control over the goods entering and/or leaving free zones is encouraged. The Secretariat considers that sharing of information among Member administrations at both bilateral and multilateral levels should be further pursued, most desirably by feeding pertinent seizure data into the CEN database. Taking into account the fact that the international Customs community is seeking the possibilities for establishing mutual authorization of economic operators, it may be worth discussing the way forward to establish a kind of joint risk management on alleged exploitation of free zones for circumvention of revenue and/or security requirements.

With this background in mind, a Customs Expert Group drafted practical guidelines, based on the experiences of some Customs administrations, in order to assist those Administrations wishing to improve, or review the controls that they deploy in Free Zones. The guide may also be of use to rights holders, in helping them to understand the background to such zones and the rationale being employed in their control.

Principles and recommendations

The International Convention on the simplification and harmonization of Customs Procedures (hereafter: the Revised Kyoto Convention) contains provisions on free zones in Specific Annex D2²⁴.

²⁴ World Customs Organisation (1974, revised 1999).



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