

Fighting Illicit Trade: Free Trade Zones



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Executive Summary

Illicit tobacco trade is one of the greatest global challenges that affects not only our industry but governments and ordinary people. It funds organized crime and terrorism, deprives public authorities of tax revenues, and misleads consumers.

Philip Morris International (PMI) is fully committed to fighting the illicit tobacco trade and would like to see greater regulation of Free Trade Zones (FTZs), which unfortunately too often facilitate the illicit manufacture and transit of tobacco products. In this paper we seek to explain the issue and provide possible solutions.

FTZs are areas of economic activity that are not confined within a given customs territory. By their nature, FTZs facilitate trade and remove administrative burden. Even though they are designed as legitimate tools, they are often

abused by criminals to hide their activities from law enforcement.

The array of illegal activities existing in FTZs varies from production of illicit whites, which are cigarettes manufactured primarily for illicit trade, to the diversion of legitimate products into the black market.

In each place, the threat posed by illicit trade depends on local conditions and presents itself differently. In many cases, the dangers are exacerbated by local laws that provide little guidance on how FTZs should operate.

This needs to be addressed, and in this paper we explain how we believe this can best be achieved.

The issues with Free Trade Zones

The revised Kyoto Convention defines FTZs as “a part of the territory (...) where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory”¹. Their primary purpose is attracting foreign investment and encouraging economic growth. FTZs accomplish these goals by simplifying customs procedures.

¹ Revised Kyoto Convention, Specific Annex D, Chapter 2.

It's easy to see why they have become so popular. They champion the exchange of goods and services in an agile way, with little or no direct taxation and much less bureaucracy. To put Free Trade Zones in perspective, they have created 70 million direct jobs.²

There is, however, a darker side to FTZs. Their overall lack of transparency and irregular or absent controls are key hurdles that must be addressed as soon as possible. We do not agree that these areas should be able to operate outside the boundaries of law.

Clear guidelines for FTZ operators are urgently needed. They should first and foremost clarify that FTZs do not enjoy extra-territorial status. This is a common misperception that leads to lax customs supervision and non-transparency.

For example, products that enter and exit Free Trade Zones pass through various economic operations (e.g. processing or repackaging) with almost no control or oversight. So if illicit activity does take place along a product's journey through FTZs, law enforcement would be blind to it. There is often no requirement to conduct due diligence of business partners, causing discrepancies between the reporting systems used by entities inside and outside the Zones. This diminishes the efficiency of any potential controls, and as a result, the accountability mechanisms for operators within FTZs.

Criminal organizations take advantage of places where there are few inspections of large shipments, and exploit the limited supervision on importation, re-labelling, export and repackaging.

We feel that it is time for stronger, more robust regulation for Free Trade Zones.



² 'Manifesto' 2014, World Free Trade Association, p.5.

Possible solutions

We support increased regulation of tobacco manufacturing and the movement of tobacco within FTZs. Better regulation is necessary, desired and overdue, as Free Trade Zones are vulnerable given the high volume of goods that transit through the Zones.

Authorities must exercise greater oversight and control over activities in FTZs. In this connection, guidance issued by international organizations must focus on mitigation through stringent controls and compliance standards. Customs authorities should be encouraged to supervise regular checks in FTZs and enforce the same controls and sanctions for illicit activity as those which apply outside of the zones.

We have identified four priority areas that must be addressed to safeguard FTZs.

Those areas are:

- Licensing;
- Due diligence;
- Labeling; and
- Tracking and tracing.

We believe that if national governments implemented the following specific measures, FTZs could be better monitored and controlled to fight against and prevent illicit trade.

Licensing

The implementation of a licensing regime inside FTZs would allow authorities to have a complete registry of those operators within FTZs dealing with tobacco products, thus facilitating the identification of those who may be involved in illicit activity.

The gravity of the situation can be seen through research conducted by KPMG, which has reported that large volumes of illicit white cigarettes are considered to originate from the Jebel Ali Free Trade Zone in the United Arab Emirates. Similar issues can be found with cigarettes manufactured in Free Trade Zones in Latin America and Asia which are illegally sold.

Countries should establish or designate a competent authority to issue licenses to

manufacture, import, export, broker, or ship tobacco products, raw materials for the production of tobacco products, and any other key inputs necessary for the production of tobacco products. Such authority should also be responsible for renewal, suspension, and canceling of the licenses, in accordance with national law. This would greatly assist in monitoring all activities which take place inside FTZs.

³ Illicit whites are cigarettes which are usually manufactured legally in one country, but are then smuggled across borders to a destination country where they have limited or no legal distribution. ⁴ KPMG, Project Sun Report, 2016 p.30



Due Diligence

Countries should require Free Trade Zone operators to conduct thorough due diligence on any entity intending to operate in the tobacco supply chain within their FTZ. We believe that FTZ operators should also monitor sales volumes to ensure that the quantities sold are commensurate with legitimate demand for such products in the ultimate destination market. Accurate inventory controls on tobacco products manufactured in or transiting through FTZs are also needed.

PMI is a responsible corporate citizen, and we are robust and thorough in the due diligence we conduct as part of our every partnership, acquisition, or agreement. Our comprehensive “know your customer” guidelines help us meet our goal of only doing business with clients that share our high standards of integrity and ethical business practices. This is a process that should be mandatory for all operators of FTZs.

If our due diligence checks result in negative findings, we choose not to do business with said companies. Free Trade Zone operators also should not do business with entities that do not pass due diligence checks and requirements, as this could ultimately result in eroding their own reputation. High compliance standards create a level playing field among FTZ operators, and can help to eliminate corrupt practices.

Furthermore, as part of a continuous due diligence compliance process, license holders should supply Free Trade Zone operators with regular reports including information on the following:

- Legitimate demand trends for tobacco products in the market of their retail sale;

- Quantity of tobacco products and manufacturing equipment in their possession; and
- Quantity of products they keep in custody or in stock, including in warehouses under duty suspension.

To avoid oversupply to certain markets, and to prevent diversion, license holders exporting tobacco products from Free Trade Zones should provide the FTZ operators with the following information before the products are shipped:

- Destination market;
- Identity of the transporter, freight forwarder, or broker;
- Estimated time of arrival of the shipment;
- Intermediate ports, if any; and
- Details on products shipped, including: brand, variant, quantity, intended market of retail sale.

Ensuring that due diligence is conducted within FTZs would help guarantee that only legitimate entities are operating within the Zones, reducing the prevalence of criminal activity and illicit trade.

Labelling

All tobacco products manufactured, repackaged or transported in FTZs should comply with labeling requirements imposed by authorities in the countries of their retail sale. Operators in FTZs should be required to destroy tobacco products that do not comply with the labeling requirements of their intended market of retail sale.

Tobacco products may be manufactured in or transit through Free Trade Zones. One of the easiest ways to identify non-compliant products is through their labeling. Since all countries specify their labeling

requirements, verifying product compliance is not burdensome and should be done in parallel to analysis of legitimate demand in their market of intended retail sale.

Tracking and tracing

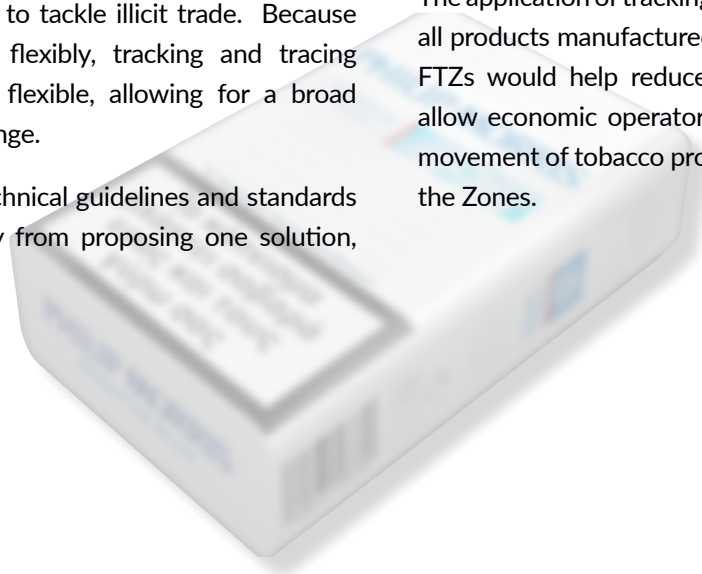
We support the application of a tracking and tracing system for products manufactured in or transiting through Free Trade Zones. We believe that illicit trade can be best fought through the establishment of a global tracking and tracing regime, which should be equally applicable within Free Trade Zones. This would ultimately enable the successful monitoring of products manufactured in, or transiting through the FTZs.

Any successful tracking and tracing system must be based on open standards, which in turn nurture competition, allowing for competing technologies and solution providers to constantly innovate and develop ways to tackle illicit trade. Because criminals operate flexibly, tracking and tracing systems must be flexible, allowing for a broad information exchange.

By establishing technical guidelines and standards and steering away from proposing one solution,

a free market for solution providers will drive permanent innovation while keeping costs proportionate to the benefits.

The application of tracking and tracing solutions for all products manufactured in or transiting through FTZs would help reduce product diversion, and allow economic operators to track and trace the movement of tobacco products within and beyond the Zones.



Conclusion

Free Trade Zones facilitate economic growth and are fundamental to an integrated global economy. Their significance is growing as globalization continues to define economic progress. Nevertheless, many FTZs are highly vulnerable to illicit trade and money laundering.

We therefore strongly believe that all entities operating within FTZs should follow best-practice supply chain controls including licensing, labeling, due-diligence and tracking and tracing for products. National authorities should monitor and exercise oversight in FTZs.

Cooperation between the authorities at the national and international level, as well as collaboration with the private sector, must be prioritized to comprehensively tackle illicit trade. Information exchange is key in identifying illegal activities and we are determined to work with authorities to eradicate illicit tobacco trade.

A universal set of best practices for Free Trade Zone operators is much needed. The objective should be to achieve a level playing field, where all legitimate participants in the tobacco supply chain are empowered and expected to operate in

line with high compliance standards. Countries must focus on enforcing laws within FTZs, a task which is long overdue.

At Philip Morris International we are committed to fighting the illicit trade and have implemented a wide range of policies and processes to do so.

Visit www.stopillegal.com to find out more information about the problem, the solution and our commitment to fighting illegal trade.



APPENDIX

Existing International Agreements

The international regulatory framework on controls within the Free Trade Zones for combating illicit trade is extensive but ambiguous. There is no unified criterion throughout the treaties and conventions that addresses the issue, resulting in contradictions that hinder the adoption of measures to increase the transparency within Free Trade Zones.



Revised Kyoto Convention

In 2006 the World Customs Organization revised and updated the International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention). This Convention was designed to help Contracting Parties achieve a modern customs administration, improve facilitation and control, as well as provide a simpler, more harmonized and flexible approach to achieve a balance between trade facilitation, customs controls, and tax collection. There are currently 110 countries that have ratified the Convention.

The Convention provides that national legislation should specify the requirements relating to Free Trade Zones, including the kinds of goods that can circulate, the nature of operations that should be allowed to take place, as well as that local customs authorities should set the arrangements for customs controls including the suitability, construction, and layout of the Zone.

The question of responsibilities within Free Trade Zones is raised within Specific Annex D, where Chapter Two refers to the role of Customs in Free Trade Zones, and describes the guidelines in relation to the establishment, management and control of Free Trade Zones, the admission of goods, authorized operations, the duration of

the stay, the assignments and the withdrawal and evaluation of the goods.

Within this chapter there are two relevant points that are worth highlighting in view of the objective of this paper:

- Standard Four, which states that customs must have an unlimited right to enter and observe operations in Free Trade Zones.
- Recommended Practice Six, on the admission of goods, which reinforces the importance of the protection of intellectual property rights and prohibiting access to counterfeit goods in Free Trade Zones.

Unfortunately, the Convention's impact has been limited by the few signatories that have adhered to Specific Annex D without reservations; with only seven countries acceding to the provisions contained in Specific Annex D without reservation. Even in cases where the provisions maintained in Specific Annex D have been adopted by a country, the effectiveness of the provisions depends fundamentally on the complementary adoption of strict national measures for the resolution of disputes and punitive actions for non-compliance. In our opinion this has been the case, leaving the system open to abuse.

The World Trade Organization's 'Trade-Related Aspects of Intellectual Property Rights' (TRIPS)

The TRIPS agreement is a multi-lateral framework developed to prevent the international trade in counterfeit goods, adopted by member states of the World Trade Organization. TRIPS requires member states to adopt measures which permit the suspension of customs procedures for counterfeit and pirated goods, and suggests specific procedures for the suspension of customs clearance for goods suspected of being counterfeit, as well as a prohibition on re-export of counterfeit goods.

The TRIPS agreement also requires member states to impose criminal penalties for willful

commercial-sale of counterfeit goods, and counterfeiting and piracy, to the same degree it penalizes other criminal acts. Unfortunately, the TRIPS Agreement makes no special provisions for Free Trade Zones. Due to the special customs treatment of Free Trade Zones, some countries have misinterpreted the Free Zones' customs regime as outside the customs jurisdiction for non-tariff matters. While the authority provided under TRIPS Article 44 enables a government to seize goods immediately after they move from the FTZ, few countries enforce these provisions.

World Customs Organization's 'Framework of Standards to Secure and Facilitate Global Trade' (SAFE)

SAFE was first adopted in 2005 to promote the movement of recognized secure trade, prevent terrorist attacks on trade, and prevent the abuse of trade to promote terrorism, through the creation of model documents which member state parties can adopt. In total 166 countries have agreed to implement measures maintained in SAFE, but in reality the application of these measures globally has not been consistent. Free Trade Zones are not

included in the SAFE provisions.

There is a failure of the above provisions to provide robust implementation measures to prevent and punish illicit trade within Free Trade Zones. Only a comprehensive global framework will create a consistent approach and help to prevent those involved in the illicit trade from exploiting Free Trade Zones in various jurisdictions.

WHO FCTC Protocol to Eliminate Illicit Trade in Tobacco Products (The Protocol)

Currently in the process of ratification, the Protocol was drafted as an international treaty aligned with the 2003 WHO Framework Convention on Tobacco Control (FCTC). Parties to the FCTC drafted the Protocol with the objective of eliminating all forms of illicit trade in tobacco products, expanding on already existing, but limited in scope, Article 15 of the FCTC. As the main global initiative to tackle illicit trade in tobacco products, including in the Free Trade Zones, the World Health Organization describes it as a global solution to a global problem.

Illicit tobacco trade has a broad impact beyond our business. Often times the damage it causes is not instantly visible by the general public. There are, however, enduring and damaging effects on society,

such as lost tax revenues, increased criminality, and facilitated access to cigarettes by youth. We will continue joining forces with the international community and the private sector to fight illicit tobacco.

This treaty is a significant milestone in the fight against illicit tobacco trade, which will become an effective regulatory framework for countries once it enters into force and is globally adopted. We recognize the FCTC, as the governing body of this treaty, and call on its parties to implement a transparent cooperation mechanism that allows for interaction with national governments, international organizations and civil society, to fight illicit tobacco trade together.

Notes

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