BLIND SPOTS:

How the Lack of Adequate Oversight in the World's Growing Number of Free Trade Zones Facilitates Illicit Financial Flows

GLOBAL FINANCIAL INTEGRITY

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Global Financial Integrity

Photo credit: Chuttersnap, Unsplash

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ABBREVIATIONS AND ACRONYMNS

5AMLD	Fifth Anti-Money Laundering Directive
ACTA	Anti-Counterfeiting Trade Agreement
AEO	Authorized Economic Operator
AML	Anti-money laundering
BASCAP	Business Action to Stop Counterfeiting and Piracy
BO	Beneficial ownership
CBP	Customs and Border Protection
CFZ	Combating the financing of terrorism
CFT	Colon Free Zone in Panama
CPTPP	Comprehensive Progressive Trans-Pacific Partnership Agreement
CTA	Corporate Transparency Act
DNFBPs	Designated non-financial businesses and professions
EPZs	Export processing zones
EU	European Union
EUIPO	European Union Intellectual Property Office
FACT	Financial Accountability and Corporate Transparency Coalition
FATF	Financial Action Task Force
FEMOZA	World Free & Special Economic Zones Federation
FIU	Financial Intelligence Unit
FTZs	Free trade zones
G-20	Group of Twenty
GAO	Government Accountability Office
GDP	Gross Domestic Product
GFI	Global Financial Integrity
ICC	International Chamber of Commerce
IFFs	Illicit financial flows
ILO	International Labor Organization
INTERPOL	International Criminal Police Organization
IPRs	Intellectual property rights
IT	Information technology
ITC	International Trade Center
KYC	Know your customer
NBFIs	Non-bank financial institutions
OECD	Organization for Economic Cooperation and Development Revised
RKC	Kyoto Convention
RUSI	Royal United Services Institute
SAD2	Chapter 2 of the Specific Annex D of the Revised Kyoto
SARs	Convention Suspicious activity reports
SEZs	Special economic zones
TBML	Trade-based money laundering
TRIPS	Trade-Related Aspects of Intellectual Property Rights
TTMA	Trinidad and Tobago Manufacturers' Association
UAE	United Arab Emirates
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
UNODC	United Nations Office on Drugs and Crime
USFTZ	United States foreign trade zone
VAT	Value-added tax
WCO	World Customs Organization
WEF	World Economic Forum
WFZO	World Free Zone Organization
WTO	World Trade Organization

EXECUTIVE SUMMARY

The international trade system has witnessed the rapid growth of various types of free trade zones (FTZs) in recent decades. These zones were established to allow goods to be imported, exported, manufactured, transformed, and stored without payment of duties or trade taxes until the point at which the goods are exported or enter into a country's domestic market. These duty-free features, along with reduced regulatory paperwork, are intended to attract investors, manufacturers, and traders to establish facilities within the zones.

In recent years, many governments around the world have been increasingly adopting stronger anti-money laundering (AML) and countering the financing of terrorism (CFT) regulations and establishing new types of due diligence requirements for financial services and other industries as a way of addressing the global problem of illicit financial flows (IFFs). There has been a similar increase in the establishment of national beneficial ownership (BO) registries by countries, which identify the actual owners of companies and help to undo the secrecy offered by anonymous shell companies and trusts. As part of undertaking such due diligence, there is also a growing awareness of the need to improve information-sharing across all key actors involved in international trade – from banks, export credit agencies, and insurers to national customs, tax, and law enforcement agencies. However, despite these important recent trends in many countries, FTZs have thus far escaped the critical governance overhaul that is required in order to meet contemporary standards on AML/CFT due diligence. This report documents the rapidly growing number of FTZs in the global economy, from a few dozen in 1970 to more than 5,000 in 2019. It also analyses the concerns that have been raised about the generally inadequate oversight of the zones by national customs officials and how the lax oversight facilitates international criminal activity and trade-related IFFs.[1]

While the major attraction for companies operating in FTZs is the reduced or omitted import taxes on goods, traders are also drawn to the speed provided by streamlined procedures and limited customs oversight in many of the zones. This report documents how some of these very attributes that attract companies to the zones – less regulatory oversight, reduced paperwork, streamlined procedures – also help facilitate illicit activity by smugglers, money launderers, and organized criminal networks. There is a growing international concern that the lack of effective customs oversight inside many FTZs is contributing to the global problems of counterfeiting, infringements on Intellectual Property Rights (IPR), smuggling, and trade-based money laundering (TBML), undermining the efforts of law enforcement to combat transnational crime and IFF's. Therefore, steps must be taken to improve customs oversight of the zones. To assist in this process, Global Financial Integrity (GFI) makes the following recommendations directed at international organizations and national governments to improve the oversight of FTZs and reduce the current degrees of opacity:

- **Deepen international cooperation on improving oversight of FTZs:** The World Customs Organization (WCO) should convene an international conference with the participation of key stakeholders such as the World Trade Organization (WTO), International Trade Center (ITC), United Nations Office on Drugs and Crime (UNODC), United Nations Conference on Trade and Development (UNCTAD), the International Criminal Police Organization (INTERPOL) and the Organization for Economic Cooperation and Development (OECD) that is designed to address the issues highlighted in this report. These parties must establish a clear, internationally agreed definition of the zones and a taxonomy that allows the world's FTZs to be identified, categorized, and counted. Critically, these parties must also take concrete steps towards an international agreement on the regulatory standards necessary to ensure the zones are not used for illicit trade, smuggling, and TBML as well as seek international agreement on expanded information-sharing protocols.

- **Establish national registries that include companies operating in FTZs:**
  All countries should: i) establish a [singular] definition of beneficial ownership (BO) and what constitutes effective/ ultimate control; ii) pass legislation

1 United Nations Conference on Trade and Development, *World Investment Report 2019: Special Economic Zones* (Geneva: UNCTAD, 2019), 138, Table IV.2, https://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=2460; François Bost, "Special economic zones: methodological issues and definition," in Transnational Corporations 26, no. 2 (2019), 141-153, https://unctad.org/system/files/official-document/diaeia2019d2a7_en.pdf.

that requires the collection of BO information at the establishment of legal entities and arrangements (including trusts) as well the same information for entities and arrangements that have already been established; iii) establish a public BO registry; and collect the BO information for all companies operating within the FTZs located within their jurisdictions;

- **Establish an updated and public WCO database on FTZs:** The WCO should create a database that provides information on: i) how many zones are operating in each country; ii) the types of zones operating in the country; iii) how many companies are operating in each zone; and iv) information regarding the owners of these companies. The WCO should update the database annually and require countries to report this information on an annual basis;

- **Get more countries to commit to RKC SAD2:** The stakeholders/parties involved in the Recommendation should establish a coordinated international campaign to get many more countries to sign and ratify the Revised Kyoto Convention, especially Chapter 2 of the Specific Annex D (RKC SAD2), which makes clear that goods located in FTZs are regarded as being outside the customs territory solely with respect to import duties/taxes levied – but the zones themselves are still part of the territory of the country in which the zone is located, and over which the national customs authority has oversight;

- **Amend legislation and change regulations that provide "extraterritoriality":** In the spirit of compliance with RKC SAD2, countries should amend any legislation or revise regulations that deny their national customs agencies full regulatory authority over both the goods and the activities inside their zones;

- **Adopt the OECD Recommendations and Code of Conduct for FTZs:** All countries – including those beyond the 38 OECD members – should adopt and fully implement the OECD's "Recommendations on Enhancing Transparency in Free Trade Zones" and adhere to the corresponding "Code of Conduct for Clean Free Trade Zones";

- **Implement the WCO Guidance on FTZs and Require AEO status:** All countries should implement the WCO's "Practical Guidance on Free Zones," should participate in the WCO's SAFE Framework, and should require all companies operating within their FTZs to meet the WCO's Authorized Economic Operator (AEO) status;

- **Use the Royal United Services Institute (RUSI) assessment tool:** Private-sector services engaged in trade, trade financing, and related activities in FTZs, such as banks, insurance companies, shipping lines, and freight forwarders, should use the freely available online risk assessment tool developed by RUSI to better understand their risk exposure to facilitating IFFs as a result of operating in an FTZ. The tool assesses FTZs by distinguishing between compliant (clean) and non-compliant (risky) FTZs.

1 INTRODUCTION

As the importance of trade in the global economy has increased in recent decades, one significant feature has been the increase in the number of free trade zones (FTZs). Initially, the zones were established to help expedite the flow of trade, and over time they also came to be viewed as a way to attract new manufacturing jobs.

Today the growing network of FTZs are considered to be playing an essential role in the contemporary global trading system by serving as transport hubs for vast global supply chains.[2] The main idea behind the zones is to offer traders reduced or omitted taxes on any goods that are imported, exported, manufactured, transformed, or stored by companies operating in the FTZs. Import tariffs are only paid at the point at which goods leave the zones and enter a domestic market for sale.

While the main attraction for companies operating in FTZs is the reduced or omitted import taxes on goods, many traders are also drawn to the speed provided by streamlined procedures, reduced regulatory paperwork and limited customs oversight in many of the zones.

Some of the standard benefits typically offered by most FTZs include:

- Exemptions from duties and taxes on the import and export of goods;
- Exemptions from duties and taxes on specific imports used for parts, equipment, and machinery in the production of exports;
- A streamlined clearance process that involves less regulatory oversight, such as fewer cargo inspections.
- Simplified customs procedures and disclosure requirements;
- Opportunities for full foreign ownership of companies operating in the zones (unlike in many countries, where regulations often limit the degree of foreign ownership);
- Opportunities to exploit "tariff-inversions" – the ability to pay the lower tariff whenever duties on a finished product are lower than the tariff(s) on the parts and components used in manufacturing the product;
- Proximity to international modes of transport.

One of the critical outcomes of globalization has been the significant increase in global trade in recent decades. Figure 1 shows that the value of total global exports jumped from 13.6 percent of global gross domestic product (GDP) in 1970 to 30.5 percent in 2019.[3] Over the same period, the total number of FTZs globally has also increased significantly, from an estimated few dozen in 1970 to more than 5,000 in 2019.[4] Given these significant increases in both global trade and the numbers of FTZs, it is reasonable to presume that an increasingly large amount of total global trade is passing through the world's growing network of FTZs. For example, one of the leading international trade associations for FTZs, the Dubai-based World Free Zone Organization (WFZO), estimated that approximately one-quarter of all global trade moves through FTZs annually.[5]

2 For an overview of how FTZs are used for various purposes in the United States, China and the European Union, see Virginia Di Nino, Simone Cigna, and Srdan Tatomir, "Breaking the "chain effect" of tariffs – foreign trade zones in the time of protectionism," *ECB Economic Bulletin*, Issue 1/2020, https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202001_03~0ebe9b9239.en.html.

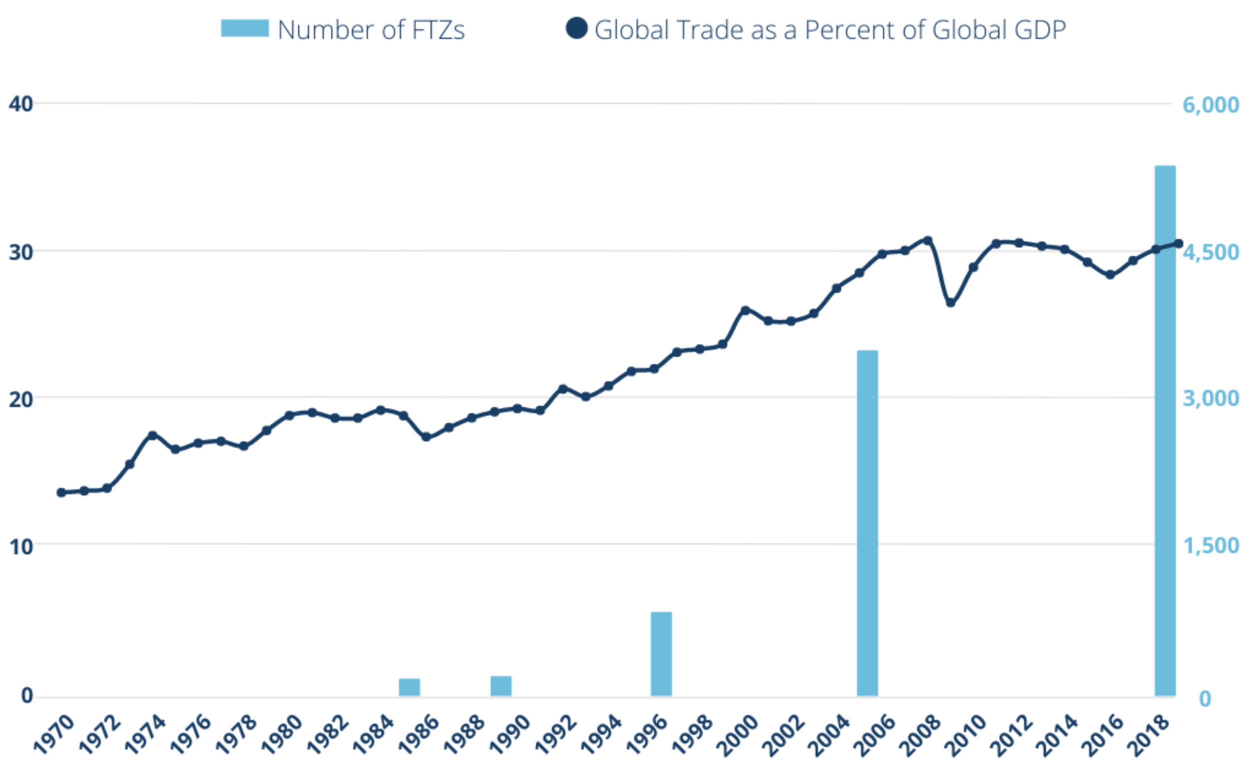
3 World Bank data, https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS?end=2019&start=1960&view=chart

4 UNCTAD, *World Investment Report 2019*, 138, Table IV.2.

5 Kasun Illankoon, "World Free Zones Organization launches Safe Zone certification program." Construction Business News, July 23, 2020. https://www.cbnme.com/logistics-news/world-free-zones-organization-launches-safe-zone-certification-program/.

The idea of specially demarcated zones designed for facilitating trade has been around in various forms throughout history. While the ancient Phoenicians are credited with first inventing the earliest versions of the zones, and the Roman Empire used them to extend its trade dominance, more contemporary forms of FTZs used to facilitate international trade were represented by Gibraltar's zone, established in 1704, and Singapore's, which was established in 1819.[6] The United States established its first foreign trade zone in New York City in 1937, followed by many others designed to "expedite and encourage international trade while promoting domestic activity and investment."[7]

Figure 1. Increases in Global Trade as a Percent of Global GDP and in the Number of FTZs, 1970-2019



Sources: United Nations, various sources.[8]

However, it was the FTZ established next to a small airport in Shannon, Ireland, in 1959, which is widely considered to be the world's first modern version of an FTZ. Initially, the Shannon FTZ had been built to serve as a refueling stop for small airplanes and, when threatened with irrelevance by the onset of long-haul international flights, it reinvented itself as a duty-free international transport, storage, and manufacturing hub that successfully attracted international companies. The initiative in Shannon was so successful that, by 1965, it produced nearly a third of all national exports of manufactured goods.[9]

The Shannon FTZ was followed by the Port of Kandla in Gujarat, India, in 1965, the Taichung Export Processing Zone in

6 Piotr Stryskowski and Bill Below, "Free Trade Zones: A Free Ride for Counterfeiters?" Organization for Economic Cooperation and Development, 2019, https://www.oecd.org/gov/risk/blog-free-trade-zones-a-free-ride-for-counterfeiters.pdf.

7 Atossa Abrahamian, "How Foreign Trade Zones In The U.S. Came Into Existence," National Public Radio, March 15, 2018, https://www.npr.org/2018/03/15/593812781/how-foreign-trade-zones-in-the-u-s-came-into-existence; Liana Wong, *U.S. Foreign-Trade Zones: Background and Issues for Congress*, Congressional Research Service,, R42686 (2019), 2, https://fas.org/sgp/crs/misc/R42686.pdf.

8 Howard Stein, "Africa, Industrial Policy, and Export Processing Zones: Lessons from Asia" (Conference paper, Africa Task Force Meeting, Addis Ababa, Ethiopia, 10-11 July 2008), 1, http://policydialogue.org/files/events/Stein_africa_ind_policy__export_processing_zones.pdf; International Labor Organization, *Economic and Social Effects of Multinational Enterprises in Export Processing Zones* (Geneva: United Nations Centre on Transnational Corporations and International Labor Organization, 1988), 2, https://www.ilo.org/public/libdoc/ilo/1988/88B09_332_engl.pdf; UNCTAD, *World Investment Report 2019*, 137-138.

9 Stryskowski and Below, "Free Trade Zones"; Eoin O'Malley, "Free Trade Zones in Ireland and Four Asian Countries," *Trocavire Development Review* (1986), 23-33, https://www.trocaire.org/sites/default/files/resources/policy/1986-free-trade-zones-ireland-asia.pdf.pdf; Wang Mingjie, "How Ireland's free trade zone model inspired the Shenzhen SEZ," *China Daily*, October 15, 2018, http://www.chinadaily.com.cn/a/201810/15/WS5bc4b2b8a310eff3032827b6.html.

Taiwan in 1971, and several others as the United Nations Industrial Development Organization (UNIDO) began promoting FTZs for developing countries in the 1960s and 1970s.[10] Since then, the increase in the number of FTZs around the world has been led by both private sector commercial interests and governments that have viewed the zones as strategic elements of countries' long-term national economic development strategies.[11]

Photo credit: Larry Williams, Unsplash

But as they have grown significantly in numbers, FTZs have also been increasingly criticized for inadequate oversight by their national customs officials. Problems with oversight of the FTZs have gained increased international attention in recent years, particularly concerning efforts to stop companies operating inside FTZs from producing counterfeit goods, infringing IPRs and engaging in TBML. Ironically, some of the very things that attract companies to the zones – less regulatory oversight, reduced paperwork, streamlined procedures – also tend to facilitate IFFs generated by illicit actors. In this sense, many FTZs have become hubs of both international trade and transnational crime.

This report reviews the growing concerns about FTZs as they relate to international efforts to combat IFFs. It explores how illicit operators exploit the opacity provided by the zones to engage in smuggling, TBML, and counterfeit goods production. Of particular concern is the lack of adequate oversight many national customs authorities have over activities within the FTZs and the problems this presents for law enforcement. At a time when governments around the world have been increasingly adopting AML/CFT regulations to crack down on IFFs in their economies, FTZs as a sector have so far escaped scrutiny. Many of the new AML/CFT due diligence procedures now required of key actors involved in international trade – from banks, export credit agencies, and insurers to customs, tax, and law enforcement agencies – are not yet required of companies operating inside the FTZs. The high degree of opacity in the zones has created a significant blind spot for law enforcement as increasing levels of global trade move through the world's growing number of FTZs.

One aspect is that, traditionally, most national customs authorities were mandated to collect trade-related revenues and were not given the remit or capacities to also address law enforcement concerns related to combating IFFs. This inability to adequately address trade-related financial crimes is a problem for customs authorities across the entire jurisdiction and extends to oversight of FTZs.

Another factor is connected to the traditional view of FTZs as functioning simply to facilitate trade, not as hotbeds of illicit activities. According to Alexandria Reid, a research analyst at the Royal United Services Institute (RUSI), customs agencies in some countries "have historically perceived free zones as 'transit' issues – effectively ignoring illicit trade or money laundering issues so long as there is no serious leakage of illicit goods or funds into the national economy."[12] But as both the volume of global trade and the numbers of FTZs have increased, it is likely that illicit goods and funds from illicit activities inside the zones are spilling over into countries' national economies.

10 Megan Maruschke, "Zones of reterritorialization: India's free trade zones in comparative perspective, 1947 to the 1980s," *Journal of Global History* 12, no. 3 (November 2017), 412, https://www.cambridge.org/core/journals/journal-of-global-history/article/abs/zones-of-reterritorialization-indias-free-trade-zones-in-comparative-perspective-1947-to-the-1980s/8542DCA652C9CFA0C783980BFF3D1BBF; Thomas Farole, *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience* (Washington D.C.: The World Bank, 2011), 31-41, https://openknowledge.worldbank.org/bitstream/handle/10986/2268/600590PUB0ID181onomic09780821386385.pdf?sequence=1&isAllowed=y.

11 United Nations Conference on Trade and Development, "Special Issue on Special Economic Zones," *Transnational Corporations* 26, no. 2. (2019) https://unctad.org/system/files/official-document/diaeia2019d2_en.pdf; Douglas Zhihua Zeng, "Global Experiences of Special Economic Zones with Focus on China and Africa: Policy Insights," Policy Research Working Paper 7240, The World Bank, April 2015, http://documents1.worldbank.org/curated/en/810281468186872492/pdf/WPS7240.pdf; United Nations Industrial Development Organization, *Industrial Development Report 2009; Breaking In and Moving Up: New Industrial Challenges for the Bottom Billion and the Middle-Income Countries* (Vienna: UNIDO, 2009), 72-79, https://www.unido.org/sites/default/files/2009-02/IDR_2009_print_0.PDF.

12 Hiba Mahamadi, "UK Free Ports Plan Risks Influx of Dirty Money, Say Experts,"October 13, 2019, https://www.riskscreen.com/kyc360/article/uk-free-ports-plan-risks-influx-of-dirty-money-say-experts/.

A third factor contributing to the lax oversight of FTZs is a popular, but technically false, misconception that the zones are imbued with a certain degree of "extraterritoriality," which the WCO explains is the idea that the zones are exempt from the laws and regulations of the rest of the country.[13] This widespread acceptance creates a range of problems. For example, not only has this emboldened FTZ owners and operators to offer an "anything goes" environment as a marketing strategy, it has even led many countries to codify the concept into law by adopting regulations and legislation that explicitly reduce and limit customs oversight within the zones.

Connected to "extraterritoriality" is the widespread misconception that the special tax treatment afforded to goods in the zones also applies to companies and activities inside the zones. In fact, while FTZs may provide generous tax breaks on goods transiting within the zones, this does not necessarily mean national customs authorities have no jurisdiction over goods or the activities of companies operating in the zones.

Furthermore, because the FTZs are thought of as operating "outside the country," the broad-based acceptance of the concept of "extraterritoriality" also reinforces a widespread perception that customs oversight is not necessary inside the zones. For example, a Panamanian commission on money laundering found that although the government had improved efforts to prevent illicit trade and money laundering within Panama's Colon Free Zone (CFZ), many cases were not prosecuted "because the illicit goods don't actually enter Panamanian territory" and the authorities had not prioritized enforcement against smuggling and other illicit activities within CFZ because "they view it as 'other countries' problems."[14]

The first section of this report reviews the basic types of FTZs worldwide and how there is no clear internationally agreed definition of FTZs, leading to difficulties with counting, classifying, and analyzing the world's growing number of zones. It then describes the concerns about how the lack of effective customs oversight inside many FTZs is being exploited for the purposes of counterfeiting IPR infringement, smuggling, and TBML. The next two sections explore why there is such a widespread lack of oversight inside the zones by national customs authorities and analyze the recent steps taken to improve customs oversight of the world's FTZs. In the final section, GFI offers a list of policy recommendations that countries can take at the national and international levels to improve the oversight of FTZs.

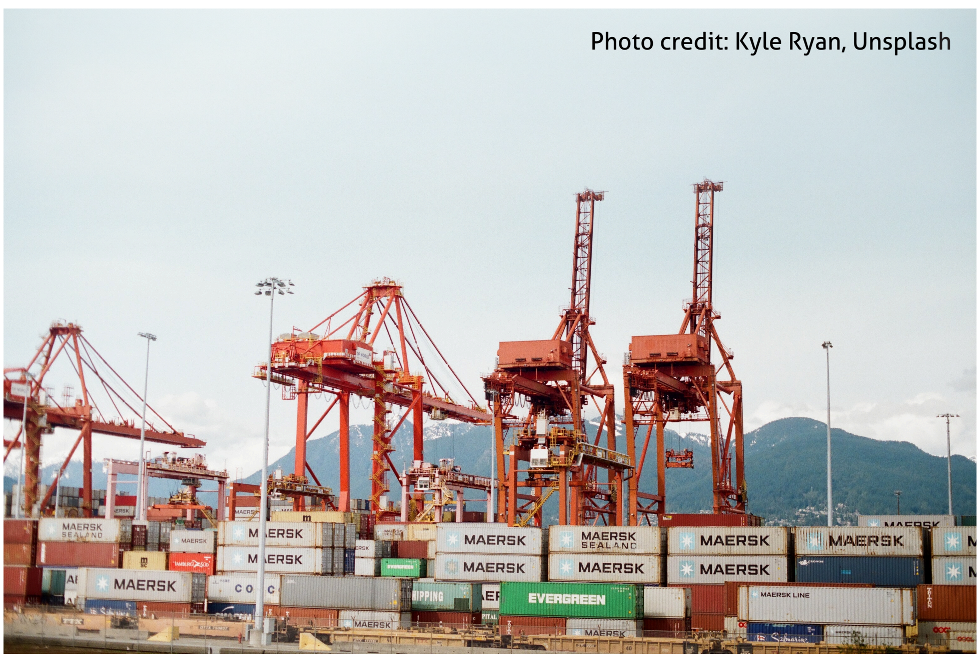


Photo credit: Kyle Ryan, Unsplash

13 Kenji Omi, "'Extraterritoriality' of Free Zones: The Necessity for Enhanced Customs Involvement," WCO Research Paper No. 47. Brussels: World Customs Organization, September 2019. http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/research/research-paper-series/47_free_zones_customs_involvement_omi_en.pdf?la=en.

14 The Economist Intelligence Unit, "2018 Global Illicit Trade Environment Index: Free Trade Zones: Five Case Studies," commissioned by the Transnational Alliance to Combat Illicit Trade, 2018,

2 WHAT'S IN A NAME? A LACK OF CLEAR DEFINITIONS OF FTZs

A significant challenge in understanding FTZs is that there are many different kinds of FTZs in operation around the world, and there are many different names used for them. Complicating matters further, different terms are commonly used for FTZs that are quite similar in their functions. Therefore, the international community presently lacks commonly agreed names and definitions of the zones. Some of the most common names of zones include special economic zones (SEZs); export processing zones (EPZs); free ports; enterprise zones; single-factory EPZs; digital FTZs; and inside the US, there are foreign-trade zones (USFTZs). Taking its lead from the Organization for Economic Cooperation and Development (OECD) and the Financial Action Task Force (FATF), this report uses "free trade zones" (FTZs) as a broad term that encompasses all types of zones.[15]

The common denominator among all types of FTZs is that they are special, demarcated areas in countries where importers, exporters, and manufacturers enjoy particularly liberalized and deregulated business conditions not available to those operating beyond their perimeters, and which are designed to attract more trade and investment. In other words, FTZs are areas where goods can be imported, stored, handled, manufactured, and/or reconfigured and re-exported without being subject to the regular customs duties, laws, or regulations of the country where the zone is located.

In the simplest sense, FTZs are defined by the International Convention on the Simplification and Harmonization of Customs Procedures, also known as the Revised Kyoto Convention (RKC), 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."[16] As the numbers and range of services provided in FTZs have increased, this more explicit definition in the RKC helps to remind us that the original purpose – and still the primary purpose – of FTZs is to offer special treatment for goods in terms of the duties and taxes applied when entering or leaving the zones.

FTZs can vary in size, types of services offered, and where they are located within a jurisdiction. FTZs can range from small, fenced enclaves that offer multinational corporations generous tax breaks and exemptions from labor laws or environmental regulations to much larger zones that offer a comprehensive array of services such as banking, conference centers, bonded warehouses, cutting-edge digital connectivity, and even childcare, housing and medical clinics for employees. Sometimes entire cities, such as Shenzhen and Hong Kong, are considered FTZs. While many zones are located near ports, others are located far inland, near airports, and in cities.. All are designed to provide proximity to various modes of transportation such as ports, railways, roads, and airports.

It is interesting to note that the terms used to refer to FTZs often vary depending on the geographic region. For example, in Central and South America, they are often called special economic zones (SEZs), whereas, in Asia and Africa, they are referred to as export processing zones (EPZs). Similarly, the UK refers to them as free ports, and the US calls them USFTZs.

Below is an overview of the various types of FTZs and their key features or functions:

15 Not included in the term FTZs used in this report are the multiple other types of smaller entities similar to Single-factory EPZs, often called free points, which are for use by individual companies, offer the same tax and financing benefits as FTZs and are estimated to number in the tens of thousands around the world. There is a debate about whether or not single-factory EPZs should be considered "zones" at all since they are more like free points because they are comprised of only a single company. See: François Bost, "Special economic zones: methodological issues and definition," in *Transnational Corporations* 26, no. 2 (2019), 147-149, https://unctad.org/system/files/official-document/diaeia2019d2a7_en.pdf.

16 *International Convention on the Simplification and Harmonization of Customs Procedures (as amended)*, Brussels, 3 February 2006, see Specific Annex D, Chapter 2, D.2/1. http://www.wcoomd.org/en/Topics/Facilitation/Instrument%20and%20Tools/Conventions/pf_revised_kyoto_conv/Kyoto_New.

TYPES OF FREE TRADE ZONES

Free Trade Zones

The FAFT and OECD use the most common general term "free trade zones" (FTZs), which they describe as effectively unregulated import/export zones where environmental, labor, tax, customs, financial and other rules are either nonexistent or less stringent than in the rest of the country.[17] The FATF notes that FTZs are typically "fenced-in, duty-free areas offering warehousing, storage and distribution facilities for trade, transhipment [sic], and re-export of products."[18]

Special Economic Zones

The World Bank and UNCTAD often use the general term special economic zones (SEZs) to describe "geographically delimited areas administered by a single body, offering certain incentives (generally duty-free importing and streamlined Customs procedures, for instance) to businesses which physically locate within the zone."[19] SEZs extend the reduced tax and administration characteristics of FTZs to include foreign investment arrangements, including exemptions for national labor laws, management practices, and wages.

Export Processing Zones

The International Labor Organization (ILO) often refers to export processing zones (EPZs) as a type of FTZ which are specifically designed as industrial areas where imported parts and components are assembled and manufactured into intermediate goods that are then exported as part of global value chains.[20] Typically, EPZs are established for labor-intensive light manufacturing such as garment production and electronics assembly. Certain hybrid models of EPZs combine export-oriented activities with non-exporting activities, such as importing components for manufacturing or raw materials for processing. Increasingly, EPZs attempt to promote forward and backward linkages with domestic firms operating outside the zones.

Free Ports

The UK and European Union (EU) often refer to FTZs as "free ports." In addition to imports, exports, and manufacturing, free ports typically include services sectors such as banking, tourism, retail sales, and housing and offer broader incentives and benefits. Free ports are intended to promote overall economic growth and to link the zones with the rest of the national economy. Some free ports have come to be used as warehouses for safe, long-term storage of valuable assets such as expensive artwork, gold, precious stones, wine collections, and antiques. In addition to the exemption from VAT and import and export duties, the main benefit is that such warehouses require no customs checks, and goods can be stored indefinitely without being declared and inventoried.[21] As of 2020, the European Commission has documented 85 free ports.[22]

17 Financial Action Task Force, *Money Laundering Vulnerabilities of Free Trade Zones* (Paris: FATF Secretariat, 2010), 8, https://www.fatf-gafi.org/media/fatf/documents/reports/ML%20vulnerabilities%20of%20Free%20Trade%20Zones.pdf; Organization for Economic Cooperation and Development and the European Union Intellectual Property Office, *Trade in Counterfeit Goods and Free Trade Zones: Evidence from Recent Trends* (Paris: OECD Publishing, 2018), 15-16, https://www.oecd.org/governance/trade-in-counterfeit-goods-and-free-trade-zones-9789264289550-en.htm.

18 FATF, *Money Laundering Vulnerabilities of Free Trade Zones*, 9.

19 World Bank, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* (Washington D.C.: World Bank, April 2008), 2, http://documents1.worldbank.org/curated/en/343901468330977533/pdf/458690WP0Box331s0April200801PUBLIC1.pdf; UNCTAD, World Investment Report 2019, 128.

20 International Labor Organization, *Note on the proceedings: Tripartite Meeting of Export Processing Zones-Operating Countries, Geneva, 28 September – 2 October 1988*, Geneva, International Labor Organization, https://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---actrav/documents/publication/wcms_114921.pdf; International Labor Organization, "How to promote decent work and workers' rights in export processing zones," November 20, 2017, https://www.ilo.org/global/about-the-ilo/newsroom/news/WCMS_599888/lang--en/index.htm.

21 Mahamadi, "UK Free Ports Plan Risks."

22 European Parliamentary Research Service, *Money laundering and tax evasion risks in free ports*, PE 627.114, October 2018, 16,

U.S. Foreign Trade Zones

In the United States, the zones are called "foreign-trade zones" (USFTZs). Originally established under the Foreign Trade Zones Act of 1934, USFTZs offer companies the opportunity to avoid paying duties legally and merchandise processing fees (MPFs), delay such payments, and pay a lower duty rate. Companies can also use tax inversions: the opportunity to choose to pay import duties on either the raw materials or finished goods, depending on which is lower. In 2019, there were 193 active USFTZs in the US (see Text Box below).[23]

Enterprise Zones

Commonly found in the more advanced economies, "enterprise zones" are specially-designated economic development areas often intended to revitalize specific urban or rural areas where special tax breaks, subsidized credit, and other types of government support programs are applied as a way of attracting new investment and employment. Examples of enterprise zones include the London Docklands and Jersey City, New Jersey.

Single Factory Zones

Some smaller types of EPZs are established for individual companies, regardless of their location or proximity to other larger FTZs. In such cases, rather than relocating its operations into a designated FTZ, an individual factory can instead have FTZ status conferred upon it in its present location and still benefit from receiving the standard duty-free incentives and privileges offered in the larger FTZs.[24]

Digital FTZs

The newest types of FTZs include "digital free trade zones", which are intended to specifically facilitate start-up companies in the information technology (IT) and e-commerce sectors, with the standard incentives and duty-free benefits. Recent examples include the Digital Free Trade Zone, an initiative established between China and Malaysia in March 2017 designed primarily to streamline e-commerce functions by removing high tax rates, customs clearances, and inspections on foreign goods,[25] and Dubai's planned digital FTZ named Dubai CommerCity, the first phase of which was launched in April 2021.[26]

https://www.europarl.europa.eu/cmsdata/155721/EPRS_STUD_627114_Money%20laundering-FINAL.pdf; For a recent list of FTZs in the EU, see: European Commission, "Free zones which are in operation in the customs territory of the Union, as communicated by the Member States to the Commission," as of April 6, 2020, https://ec.europa.eu/taxation_customs/system/files/2020-04/list_freezones.pdf.

23 International Trade Administration, "U.S. Foreign Trade Zones," accessed May 2020, https://www.trade.gov/foreign-trade-zones-board; Foreign Trade Zones Board, *81st Annual Report of the Foreign-Trade Zones Board to the Congress of the United States* (Washington, D.C.: Foreign Trade Zones Board, November 2020), 1, https://enforcement.trade.gov/ftzpage/annualreport/ar-2019.pdf; For an updated list of FTZs in the United States, see "FTZ Reading Room," International Trade Association, accessed May 17, 2020, https://www.trade.gov/reading-room.

24 Bost, *Transnational Corporations,* 147-148

25 Hugh Harsono, "The China-Malaysia Digital Free Trade Zone: National Security Considerations," *The Diplomat,* July 25, 2020, https://thediplomat.com/2020/07/the-china-malaysia-digital-free-trade-zone-national-security-considerations/

26 Government of Dubai Media Office, "Dubai CommerCity launches first phase of its new facilities," April 18, 2021, https://mediaoffice.ae/en/news/2021/April/18-04/Dubai-CommerCity.

This wide variety of FTZs terms has made it difficult to develop a comprehensive taxonomy of FTZs and their different categories, sizes, and functions in the global economy. And without a common classification system, it is difficult to know how much global trade is moving through the world's zones in each year. Despite this, some organizations have attempted to estimate the number of FTZs that exist in the global economy. For example, the World Bank reported that the number of FTZs had increased from 79 zones located in 25 countries in 1975 to over 3,000 in 135 countries by 2008.[27] In 2014, the ILO reported that the number of EPZs had increased from 176 zones located in 47 countries in 1986 to 3,500 zones in 130 countries by 2006.[28] And in 2015, *The Economist* put the global count of SEZs at 4,300.[29] Finally, the most recent estimate was conducted by UNCTAD in 2019, which identified 5,383 SEZs located in 140 countries, as well as an additional 500 new SEZs being developed (see Table 1).[30] UNCTAD reported that the countries with the largest numbers of SEZs in 2019 included: China, the Philippines, India, the United States, Russia, Turkey, Thailand, the Dominican Republic, Kenya, and Nicaragua.[31]

27 World Bank, *Special Economic Zones*, 23.

28 International Labor Organization, *Trade Union Manual on Export Processing Zones* (Geneva: International Labor Organization, 2014), 4, Table 2, https://www.ilo.org/wcmsp5/groups/public/@ed_dialogue/@actrav/documents/publication/wcms_324632.pdf.

29 *The Economist*, "Not so special," April 4, 2015, https://www.economist.com/leaders/2015/04/04/not-so-special.

30 UNCTAD, *World Investment Report 2019*, 128, Table IV2.

31 For a recent list of FTZs in China, see Khoonming Ho and Lewis Lu, "China: China Introduces New Free Trade Zones and Improved Practices," *International Tax Review*, October 15, 2019, https://www.internationaltaxreview.com/article/b1hlmhtmp7dhtb/china-china-introduces-new-free-trade-zones-and-improved-practices; Regarding new FTZs in China, see Joshua Henderson, "China's New Free Trade Zones: A Pivot Inward?" *New Perspectives on China (blog)*, Center for Strategic and International Studies, October 23, 2020, https://www.csis.org/blogs/new-perspectives-asia/chinas-new-free-trade-zones-pivot-inward.

Table 1. The Number of FTZs in the World, FTZs Under Development and FTZs Being Planned, in 2019

Region	Number of FTZs	FTZs Under Development	FTZs Being Planned
Developed Economies			
Europe	105	5	--
North America	262	--	--
Other Developed Economies*	7	--	--
Developing Economies			
East Asia	2,645	13	--
China	2,543	--	--
Southeast Asia	737	167	235
South Asia	456	167	184
India	373	--	--
Oceania**	3	--	--
Middle East	208	24	--
Africa	237	51	53
Latin America and the Caribbean	486	28	24
Transitional Economies^	237	18	5
Total	5,383	473	501

Source: Data derived from UNCTAD, World Investment Report 2019.
*Other developed economies include: Australia; Bermuda; Israel; Japan; New Zealand
**Oceania includes: Cook Islands; Fiji; French Polynesia; Kiribati; Marshall Islands; Micronesia, Federated States of; New Caledonia; Palau; Papua New Guinea; Samoa; Solomon Islands; Tonga; Tuvalu; and Vanuatu.
*Transition Economies include: South-East Europe (Albania; Bosnia and Herzegovina; Montenegro; North Macedonia; Serbia), the CIS countries (Armenia; Azerbaijan; Belarus; Kazakhstan; Kyrgyzstan; Moldova, Republic of; Russian Federation; Tajikistan; Turkmenistan; Ukraine; Uzbekistan), and Georgia.

Spotlight: United States Foreign-Trade Zones (USFTZs)

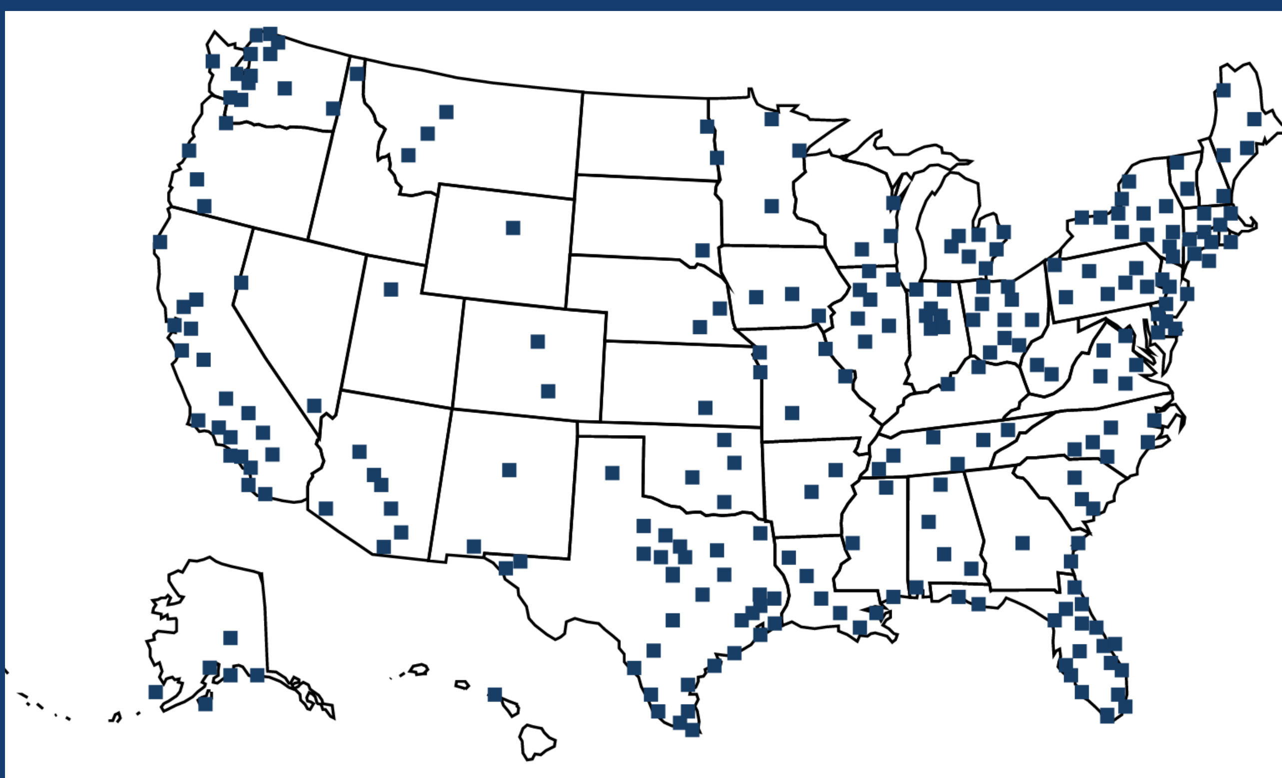
Originally established under the Foreign Trade Zones Act of 1934, USFTZs offer companies the opportunity to legally avoid paying duties and merchandise processing fees, delay such payments, and pay a lower duty rate. In addition, companies can take advantage of tax inversions.

The national system is administered by the U.S. FTZ Board, which is comprised of the Secretaries of Commerce and the Treasury. The board is responsible for establishing new zones, authorizing specific production activities, and providing general oversight of zones. In addition to the two Secretaries, the U.S. FTZ Board appoints an Executive Secretary who oversees the board's staff.

The U.S. Department of Homeland Security's Customs and Border Protection (CBP) enforces regulations set by the board, directly carries out customs-related functions, authorizes new zones, and secures and controls dutiable merchandise moving into and out of them. CBP oversight also includes both collections of U.S. tariff revenue and protection from illegal activity through screening, targeting, and inspections.

The economic activity associated with USFTZs represents a significant share of total U.S. trade. In 2019, there were 193 USFTZs active with 3,300 firms working in the zones that employed 460,000 persons, including 348 companies that were engaged in manufacturing activities in the zones.[32] Foreign goods entering the U.S. through its FTZs accounted for almost 10 percent of total U.S. imports in 2019.[33]

Figure 2. Foreign Trade Zones in the United States in 2019



Source: Wong, U.S. Foreign Trade Zones. The map is not to scale. The purpose is to show the approximate location and number of Foreign-Trade Zones in each state.

32 Foreign Trade Zones Board, 81st Annual Report, 1.
33 Wong, U.S. Foreign-Trade Zones, 8.

The degree of oversight within USFTZs is qualitatively different from that of many other zones around the world. This is likely because most of the goods are destined for eventual entry into the U.S. market and will go through a rigorous CBP entry process, whereas a much higher percentage of goods going through most other FTZs around the world are typically being exported or re-exported to other markets. Moreover, the CBP is allowed access to all USFTZs, and can conduct audits (including unannounced audits) and compliance reviews to verify whether the zone operator is properly supervising the zone and maintaining the records in compliance with the laws and regulations.[34]

Despite having a higher level of oversight than many of their foreign counterparts, investigations by the U.S. Government Accountability Office (GAO) have questioned the effectiveness of relevant government agencies in performing their responsibilities. For example, an August 2017 GAO study found that the CBP had failed both to conduct a program-wide compliance risk assessment and compile this information in a central location.[35] Likewise, a November 2018 GAO report found that, when authorizing applications for proposed activities in USFTZs, Board staff did not document consideration of all required criteria in accordance with Standards for Internal Control in the Federal Government, such as if the activities complied with U.S. trade and tariff law, etc., before recommending whether the applications should be authorized.[36] The GAO's concern was that without such documentation, "the Board lacks an institutional record that all required criteria were considered and also lacks assurance that its decisions comply with U.S. trade and tariff law and public policy."[37]

In response, the USFTZs Board updated its procedures, which now require the examiner's report to document the examiner's analysis for each criterion found in federal regulations. Regarding both CBP and the USFTZs Board, the shortcomings were partly linked to a lack of documentation and data collection. Following these GAO reports, both entities have improved their procedures.[38]

The U.S. took an important step forward in January 2021 with the passage of the Corporate Transparency Act (CTA) as part of the National Defense Authorization Act. The law requires certain privately held companies in the U.S. to report beneficial ownership information to the U.S. Treasury Department's Financial Crimes Enforcement Network.[39] The reporting of beneficial ownership information, which identifies the actual individual(s) directly or indirectly controlling a company or owning 25 percent or more of the ownership interests of a company, serves to strengthen law enforcement with AML/CFT efforts in the context of the increased use of anonymous shell companies for illicit financial activities. As USFTZs are considered part of the state in which they are located, any foreign-owned companies that operate within one would be registered with the relevant state, and would therefore be subject to CTA requirements. It is notable that there is no publicly available information on the number and/or type of foreign-owned companies operating as either zone operators or zone users within USFTZs because the board does not report this data in its annual reports to the U.S. Congress. The CBP, which provides the permits for companies to conduct activities inside the zones, has such data on foreign ownership but does not make it publicly available.

34 Organization for Economic Cooperation and Development, *Governance Frameworks to Counter Illicit Trade* (Paris: Organization for Economic Cooperation and Development, March 2018), 124, https://www.oecd-ilibrary.org/governance/governance-frameworks-to-counter-illicit-trade_9789264291652-en; United States Customs and Border Protection, Foreign Trade Zones Manual (Washing-ton D.C.: U.S. Customs and Border Protection, 2011), 29-33, https://www.cbp.gov/sites/default/files/documents/FTZmanual2011.pdf.

35 United States Government Accountability Office, *Foreign Trade Zones: CBP Should Strengthen Its Ability to Assess and Respond to Compliance Risks across the Program*, GAO-17-649 (Washington D.C.: Government Accountability Office, July 2017), 27-28, https://www.gao.gov/products/GAO-17-649.

36 United States Government Accountability Office, Foreign Trade Zones: Board Should Document Consideration of All Required Criteria When Evaluating Applications, GAO-19-91 (Washington D.C.: Government Accountability Office, November 2018), 38, https://www.gao.gov/assets/700/695677.pdf.

37 United States Government Accountability Office, Foreign Trade Zones (2018), 1.

38 Wong, U.S. Foreign-Trade Zones, 19.

39 Thomas Appleman and Arthur Griem, "New Corporate Transparency Act Will Impose Beneficial Ownership Reporting Requirements on Many Companies, Particularly Small Businesses." The National Law Review, January 8, 2021. https://www.natlawreview.com/article/new-corporate-transparency-act-will-impose-beneficial-ownership-reporting

3 COUNTERFEIT GOODS AND INTELLECTUAL PROPERTY RIGHTS INFRINGEMENT IN FTZs

Counterfeiting and IPR infringement is a lucrative transnational crime that can can pose serious threats. Not only do counterfeit goods have a number of deleterious economic effects on legitimate businesses and IPR holders, but the introduction of counterfeit goods raises several public health concerns regarding product safety, particularly regarding the dangers posed by counterfeit medicines.

Many international bodies and multilateral institutions have voiced concerns about lax oversight in FTZs. For example, the European Parliament's 2018 report noted that free ports are "conducive to secrecy."[40] The concern that such secrecy is facilitating counterfeiting activities was underscored in a 2010 FATF report on FTZs, which found that not only did many zones lack adequate safeguards against terrorist financing and money laundering, FTZs were also a haven for counterfeiting.[41] As low-cost territories with industries that can provide all kinds of services from re-labeling to repackaging, and with less oversight and fewer inspections, "FTZs are one of the favorite zones of all counterfeiters."[42]

A study by the International Chamber of Commerce (ICC) on the economic impact of counterfeiting and piracy found "the lack of controls has made the free-trade areas attractive locations for parties engaging in trade of counterfeit/pirated products."[43] Similarly, a 2012 report by the World Economic Forum referred to FTZs as "enablers of organized crime" due to their relaxed oversight, lack of transparency, deficient AML/CFT safeguards, "inadequate coordination and cooperation between FTZ and customs authorities," and differences in regulations in various regions of the world.[44]

A related oversight problem is that some customs authorities may delegate the management of small shipments to transport companies. Although intended to facilitate the flow of the increasing number of "e-parcels," or goods bought from online retailers, shipping through transport companies also helps counterfeiters to remain anonymous because the transport company often gets listed as the exporter on the package, making it impossible for customs authorities to trace the actual suppliers of intercepted counterfeit e-parcels.[45]

The same attributes that make FTZs attractive to investors, manufacturers, and traders also make FTZs ideal locations for the production and transit of counterfeits. An OECD report detailed how counterfeiters import goods into FTZs to "sanitize" shipments, disguise their origin, add counterfeit trademarks, manufacture and repackage finished counterfeit goods for export, warehouse counterfeits, store counterfits and use FTZs as gateways for smuggling and trans-shipping fake products, all with little or no risk of IPR-related enforcement.[46] According to the European Commission, an analysis of 82 free ports or FTZs in the EU found that FTZs facilitate movement of counterfeit goods because they "allow counterfeiters to land consignments, adapt or otherwise tamper with loads or associated paperwork, and then re-export products without customs intervention."[47]

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40 European Parliamentary Research Service, *Money laundering and tax evasion risks*, 14.

41 Financial Action Task Force, *Money Laundering Vulnerabilities of Free Trade Zones*, 4, 19.

42 Hernan Albamonte, "Free Trade Zones: A Driver For Illicit Trade," *Medium.com,* June 13, 2019, https://medium.com/@hernan.albamonte/free-trade-zones-a-driver-for-illicit-trade-c47476e43505.

43 Organization for Economic Cooperation and Development, *The Economic Impact of Counterfeiting and Piracy*, (Paris: Organization for Economic Cooperation and Development, June 2008), 85, https://read.oecd-ilibrary.org/trade/the-economic-impact-of-counterfeiting-and-piracy_9789264045521-en#page87; International Chamber of Commerce, *Controlling the Zone: Balancing facilitation and control to combat illicit trade in the world's Free Trade Zones*, (Paris: International Chamber of Commerce, May 2013), 6-8, https://iccwbo.org/publication/controlling-the-zone-balancing-facilitation-and-control-to-combat-illicit-trade-in-the-worlds-free-trade-zones-2013/.

44 World Economic Forum, "Organized Crime," in *Network of Global Agenda Councils Reports 2011 – 2012* (Cologny, Switzerland: World Economic Forum, June 2012), http://reports.weforum.org/global-agenda-council-2012/#view/global-agenda-council-2012/councils/organized-crime/.

45 Edward Pearcey, "Free Trade Zones: The Problem Child of Global Trade," World Intellectual Property Review, November 17, 2020, https://www.worldipreview.com/article/free-trade-zones-the-problem-child-of-global-trade.

46 Organization for Economic Cooperation and Development, *Economic Impact of Counterfeiting and Piracy*, 85.

47 European Commission, Report from the Commission to the European Parliament and the Council on the assessment of the risk of money laundering and terrorist financing affecting the internal market and relating to cross-border activities (Brussels: European Commission, July 2019), 5, https://ec.europa.eu/info/sites/default/files/supranational_risk_assessment_of_the_money_laundering_and_terrorist_financing_risks_affecting_the_union.pdf.

"In most EU free ports or customs warehouses, precise information on the beneficial owners is not available."

--THE EUROPEAN COMMISSION

Criminal networks tend to ship counterfeit products via complex trade routes, using multiple FTZs as transit points to "cleanse" the associated documents and obscure the original point of production and/or departure. FTZs are used to process products by adding counterfeit trademarks and/or repackaging or re-labeling goods. FTZs are also used as distribution centers for counterfeit and pirated goods to transfer them to their final destination points in smaller orders.[48]

Using multiple FTZs and ports of transit also enables counterfeiters to disburse their activities across multiple jurisdictions. For example, a product may be legally produced in one country but then illegally re-labeled with counterfeit logos or packaged in another country with weaker IPR enforcement closer to a destination market.

Customs Inspection, Wilmington DE, Photo Credit: CBP Website

Such a game of "musical chairs" serves to disguise the fake products' illegal origins and considerably undermines efforts by customs authorities and law enforcement agents to identify counterfeits.[49] For example, the seizure of a consignment of pharmaceutical products at Heathrow airport in the UK, which was in transit from the Sharjah FTZ in Dubai to a pharmacy located in the FTZ of Freeport, Bahamas, provides an example of how multiple FTZs are used to facilitate international IPR crimes.[50]

A 2016 joint study by the OECD and the European Union Intellectual Property Office (EUIPO) estimated the total value of the international trade in counterfeit and pirated products at US$461 billion in 2013, which was equivalent to 2.5 percent of imported goods worldwide, and 5 percent of all imports within the EU.[51] Emphasizing the growth of counterfeiting, a 2017 study prepared for the ICC's Business Action to Stop Counterfeiting and Piracy (BASCAP) and the International Trademark Association estimated that the total global economic value of counterfeiting and piracy could be as much as US$2.8 trillion by 2022.[52]

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48 William Dobson, "Balancing trade facilitation and control to comb illicit trade in the world's Free Trade Zones," *World FZO Bulletin, Issue 07*, September 2016, 7, https://www.worldfzo.org/Portals/0/OpenContent/Files/446/World_FZO_Bulletin07.pdf;

49 Ibid.

50 Europol and the European Union Intellectual Property Office, *2017 Situation Report on Counterfeiting and Piracy in the European Union* (Brussels: Europol and EUIPO, June 2017), 25, https://www.europol.europa.eu/publications-documents/2017-situation-report-counterfeiting-and-piracy-in-european-union.

51 Organization for Economic Cooperation and Development and the European Union Intellectual Property Office, *Trade in Counterfeit and Pirated Goods: Mapping the Economic Impact* (Paris: OECD and EUIPO, 2016), 11, https://www.oecd-ilibrary.org/docserver/9789264252653-en.pdf?expires=1621445533&id=id&accname=guest&checksum=44493F64E3BBF640A933D552EC0BD9F9.

52 Frontier Economics, The Economic Costs of Counterfeiting and Piracy: Report prepared for BASCAP and INTA (London: Frontier Economics, January 2017), 8, Table 1, https://www.iccwbo.be/wp-content/uploads/2017/06/ICC-BASCAP-Frontier-report-2016-Executive-Summary.pdf.

Counterfeit and pirated goods lead to health and safety risks, product malfunctions, a loss of income for companies through infringement on their trademarks and copyrights, and a loss of proper trade taxes paid to governments. The following case study of FTZs in Trinidad and Tobago highlights how the mix of counterfeiting and FTZs impacts one country.

Case Study: Trinidad and Tobago

Free Trade Zones: A Double-Edged Sword?

Trinidad and Tobago's Free Zones Program was originally designed to "encourage local and foreign investment in export-driven projects that create jobs, develop skills, and create external markets for products."[53] The FTZs are administered by the Trinidad and Tobago Free Zones Company Ltd. under the Free Zones Act of 1988.

However, many of the leading industry associations are increasingly aware of the economic costs associated with illicit trade, including a loss of revenue to the government, the entry of substandard goods into the domestic market, and the erosion of legitimate businesses (which can negatively affect many jobs). In response, the Trinidad and Tobago Manufacturers' Association (TTMA) formed its Illicit Trade Desk in 2018 as part of its effort to specifically address these problems, raise awareness about the issue, and reduce the level of illicit trade in Trinidad and Tobago. With reference to the role of FTZs, the TTMA has stated that it views the zones as "a double-edged sword" because while they support many legitimate trade activities, they can also have devastating effects when they are used for criminal purposes.

The TTMA's Illicit Trade Desk reportedly stated that FTZs are "like havens for illicit trade" and has raised concerns about the degree to which the government's Customs and Excise Division has sufficient oversight of activities underway inside the zones, if goods are being regularly inspected and if "companies operating in these zones are subject to rigorous disclosure and transparency requirements."[54]

As the number of FTZs increases, so does the number of opportunities for counterfeiters. In 2018 the OECD and the EUIPO jointly undertook a quantitative analysis of the relationship between FTZs and counterfeit goods. They found that the existence, number, and size of FTZs increase the value of counterfeit and pirated products exported by a given economy. The findings indicated that for every additional FTZ established within an economy, the percentage of counterfeited exports increases by an average of 5.9 percent.[55] The study also estimated that a one percent increase in the value of exports from EPZs within an economy is associated with a 0.28 percent increase in the value of counterfeit and pirated products exported from that economy; a one percent increase in the number of firms operating in EPZs and in the number of employees working in EPZs within an economy raises the value of counterfeit and pirated exports by 0.29 percent and 0.21 percent, respectively; and an increase of one percent in the value of investments in EPZs raises the value of fake exports by 0.17 percent.

53 Republic of Trinidad and Tobago Ministry of Trade and Industry, Special Economic Zones Policy for Trinidad and Tobago (Port of Spain: Ministry of Trade and Industry, 2019) 23, https://tradeind.gov.tt/wp-content/uploads/2019/10/National-SEZ-Policy.pdf

54 Trinidad and Tobago Manufacturers Association, "Free Trade Zones are havens for illicit trade," *The Daily Express,* March 2, 2021, https://trinidadexpress.com/press-releases/free-trade-zones-are-havens-for-illicit-trade/article_e1b95fae-7b5c-11eb-adef-ef6744b3336f.html.

55 Organization for Economic Cooperation and Development (OECD) and the European Union Intellectual Property Office (EUIPO), "Trade in Counterfeit Goods and Free Trade Zones: Evidence from Recent Trends." Paris, March 2018, 13, https://www.oecd.org/governance/trade-in-counterfeit-goods-and-free-trade-zones-9789264289550-en.htm.

"FTZs are like havens for illicit trade."
--THE TRINIDAD AND TOBAGO MANUFACTURERS' ASSOCIATION ILLICIT TRADE DESK

Essentially, the study suggested that the larger the size of the EPZs in an economy, the greater the value of fake products the economy exports globally.[56] Most recently, in the context of the COVID-19 crisis, there is a growing concern about the role of FTZs posing a significant threat to the safety of vaccine supplies, particularly in Africa and other regions with insufficient customs oversight. The Africa Free Zones Association determined that as of 2019, there were 189 FTZs located in 47 of the 54 African countries.[57] According to experts, when the vaccines are being shipped through African FTZs, the supply chain "will be most at risk of criminals inserting fake and substandard" products.[58]

For example, China and India are the leading sources of vaccine supplies to many countries in Africa, and those countries with ports on Africa's east coast are of increasing importance for addressing the pandemic. However, one of the leading ports in the region is Kenya's Mombasa port, which is an FTZ that is widely considered to be one of Africa's major conduits for falsified and substandard medicines. Also of concern is the refurbished port in Djibouti, which serves as a major entry point for Chinese products into Africa.[59] With about US$3.5 billion in development financing from China, the port in Djibouti is slated to become Africa's largest FTZ, which worries international crime experts because the Djibouti port lacks an electronic record of brands/trademarks and products that enter a country.[60] These concerns are furthered by the lack of an African continental or global strategy to stop the spread of fake COVID-19 vaccines.[61]

When the vaccines are being shipped through the FTZs, the supply chain will be most at risk of criminals inserting counterfeit and substandard ingredients.

One of the key reforms needed is increased coordination with FTZ administrators across computerized document management systems. Presently, there is a widespread lack of such automated (IT) system coordination in many FTZs, which, according to the World Trademark Review, would make them "easy targets for re-documenting shipments and hiding the origin, content, and destination of illicit goods."[62] This essentially turns FTZs into hubs for laundering and distributing counterfeit goods.[63]

International trade conventions and agreements governing the enforcement of IPRs have not kept pace with the rapid increase in the exploitation of FTZs by counterfeiters. For example, currently, the world's leading international agreement to help countries address counterfeiting is the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement with the WTO. However, the TRIPS Agreement primarily addresses the obligations of countries with respect to goods being shipped by the original exporting countries and the final destination importing countries but does not include similar obligations for the treatment of those goods which are only transiting through countries, such as many goods which go through FTZs. [64]

56 Ibid, 53.

57 Africa Free Zone Association, Africa Economic Zones Outlook (Cape Town: Africa Free Zone Association, March 2020), 5, https://www.africaeconomiczones.com/wp-content/uploads/2020/03/African-Economic-Zones-Outlook-1.pdf.

58 Darren Taylor, "Crime and (no) punishment: Why Africa's ports are vulnerable to counterfeit COVID vaccines," Bhekisisa Centre for Health Journalism, February 18, 2021, https://bhekisisa.org/article/2021-02-18-crime-and-no-punishment-why-africas-ports-are-vulnerable-to-counterfeit-covid-vaccines/; Marius Schneider, Vanessa Ferguson, and Nora Ho Tu Nam, "The real problem of fakes in Africa: enabling factors and advice to rights holders," *Journal of Intellectual Property Law & Practice* 15, no. 5 (May 2020), https://academic.oup.com/jiplp/article-abstract/15/5/365/5818119?redirectedFrom=fulltext.

59 Taylor, "Crime and (no) punishment."

60 Ibid.

61 United Nations Office on Drugs and Crime, "COVID-19-related Trafficking of Medical Products as a Threat to Public Health," Research Brief, Vienna, July 2020, https://www.unodc.org/documents/data-and-analysis/covid/COVID-19_research_brief_trafficking_medical_products.pdf.

62 Sophie Peresson, "Controlling the zone," *World Trademark Review*, April 23, 2020, https://www.worldtrademarkreview.com/anti-counterfeiting/controlling-the-zone.

63 Ibid.

64 Dobson, "Balancing trade facilitation and control," 7.

There are a few examples of international conventions that explicitly encompass FTZs within their regulatory scope, such as the Anti-Counterfeiting Trade Agreement (ACTA) and the Intellectual Property chapter of the Comprehensive Progressive Trans-Pacific Partnership Agreement (CPTPP).

There is a widespread lack of IT system coordination in many FTZs.

While the ACTA, which had been designed to harmonize and enforce IPR provisions in existing trade agreements among its signatories, was a step in the right direction, it ultimately failed due to the way it had been drafted, primarily because of opaque negotiations and a lack of consultation and broader public support.[65] The CPTPP, which came into force on December 30, 2020, contains a new obligation for parties to detain goods suspected of trademark infringement upon import, including for goods in transit (primarily FTZs).

However, it is unclear whether the implementing laws adopted by Australia, Canada, and New Zealand to comply with the CPTPP, "most notably regarding anticounterfeiting border measures," actually comply with the IP-related provisions and requirements of the CPTPP.[66] In contrast to those efforts, the Protocol to Eliminate Illicit Trade in Tobacco Products, which entered into force on September 25, 2018, explicitly provides effective controls over illicit tobacco in FTZs.[67] But this protocol, which only deals with the singular issue of tobacco products, is the exception, not the rule.

Therefore, there is a general lack of comprehensive, internationally binding agreements about standards of IPR enforcement within FTZs. According to BASCAP, an initiative of the ICC, the absence of international standards on IPR enforcement within FTZs "has produced a sense of perceived immunity over goods in these zones, creating exactly the type of environment that allows counterfeiters and organized crime groups to flourish."[68]

Even more worrisome from a regulatory perspective is the trend by which different countries apply different types of unique laws and regulations regarding the amount of oversight authority given to their national customs authorities within their FTZs. In some countries, it is increasingly questioned if customs authorities have any jurisdiction to exercise oversight control in FTZs. [69]


Photo credit: Erik Odin, Unsplash

It is increasingly clear that to solve the growing problem of counterfeiting within the world's FTZs, legislative or other regulatory steps must be taken by nations to ensure that IPR enforcement is extended to include FTZs and that counterfeiting activities of all kinds must be outlawed within the zones. Furthermore, national customs and law enforcement authorities should be legally empowered to take action against counterfeit and pirated goods in transit and transshipment within FTZs.

65 Luciano Floridi, "The anti-counterfeiting trade agreement: the ethical analysis of a failure, and its lessons," *Ethics and Information Technology* 17, no. 2 (July 2015), https://www.researchgate.net/publication/282477351_The_anti-counterfeiting_trade_agreement_the_ethical_analysis_of_a_failure_and_its_lessons.

66 United States Chamber of Commerce, *Art of the Possible: U.S. Chamber International IP Index*, Eighth Edition (Washington D.C.: U.S. Chamber of Commerce, 2020), 31, https://www.theglobalipcenter.com/wp-content/uploads/2020/02/GIPC_IP_Index_2020_FullReport.pdf.

67 World Health Organization, "Protocol to eliminate illicit trade in tobacco products," entered into force September 25, 2018, 20, Article 12, http://apps.who.int/iris/bitstream/handle/10665/80873/9789241505246_eng.pdf;jsessionid=2AFF089ECFD2F09BA44985986C0C6470?sequence=1.

68 Dobson, "Balancing trade facilitation and control," 7.

69 Omi, *Extraterritoriality' of Free Zones: The Necessity for Enhanced Customs Involvement.*

4 TRADE-BASED MONEY LAUNDERING IN FTZS

According to FATF – the global standard-setter for best practices in national AML/CFT regulations – TBML involves the process of disguising the proceeds of crime and moving value across borders by using international trade transactions in ways that appear to legitimize the illicit origins. Indeed, FATF has classified FTZs as significantly vulnerable to money laundering activities due to the high risk of TBML practices, such as falsifying the price, quantity, or quality of imports or exports on invoices. With specific regard to AML/CFT concerns, a 2010 report by FATF report found:

- FTZs "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… 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;
- "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;
- "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;
- "The lack of international cooperation between competent authorities and law enforcement including Financial Intelligence Units within FTZs… [complicates] the fight against fraud and the laundering of money channeled through these zones."[70]

The FATF report concluded that TBML is a prevalent method used in FTZs and represents a "substantial vulnerability."[71]

FTZs are "significantly vulnerable to money laundering activities."

--FINANCIAL ACTION TASK FORCE

Although many national customs authorities have sought to strengthen their AML/CFT efforts in recent years with the adoption of comprehensive, government-wide IT management systems to improve coordination and oversight, there is a concern that such improved capacities are not being applied to companies and activities inside the FTZs.

A 2019 survey report by the WCO found that FTZs generally lack sufficient customs involvement in the operation of the zones and that there is often insufficient integration of IT systems by governmental agencies inside FTZs.[72] In a striking conclusion, the report found that the very limited degree of involvement and limited authority of customs agencies inside many FTZs "render Customs' risk-management-based controls…virtually useless."[73]

Similar concerns about the use of FTZs as platforms for money laundering have been raised in the annual reports by the US State Department's Bureau of International Narcotics and Law Enforcement Affairs, which noted that, along with offshore centers and gaming enterprises, FTZs "continue to attract illicit funds" because they "offer convenience and, often, anonymity to those wishing to hide or launder the proceeds of narcotics trafficking and other serious crimes."[74]

70 Financial Action Task Force, *Money Laundering Vulnerabilities of FTZs,* 27-28. 72

71 Ibid, 28.

72 Omi, "'Extraterritoriality' of Free Zones,"

73 Ibid, 3.

74 United States Department of State, Bureau of International Narcotics and Law Enforcement Affairs, International Narcotics Control Strategy Report 2018, Volume II: Money Laundering (Washington, D.C.: US Department of State, March 2018), 16, https://www.state.gov/wp-content/uploads/2019/04/2018-INCSR-Vol.-II.pdf.

FTZs "continue to attract illicit funds."

-- US STATE DEPARTMENT'S BUREAU OF INTERNATIONAL NARCOTICS AND LAW ENFORCEMENT AFFAIRS

Recent annual reports have noted the following concerns about various FTZs located in countries around the world:

- **Belize:** "Belizean law enforcement agencies strongly suspect there is money laundering, illicit importation of duty-free products, and large sums of cash moving through… Belize's two FTZs, Corozal and Benque Viejo, on the border with Mexico and Guatemala, respectively."[75] "[Both] FTZs are managed entirely by the private sector, are seldom monitored, deal in cash, and are an entry and dissemination point for contraband;"[76] The 2020 report found: "Belize remains primarily a cash economy, including in its two operational free zones. The FTZs are managed entirely by the private sector, deal in cash, and are an entry and dissemination point for contraband. The government is redrafting the Free Zones Act, which will require companies to submit more information on their activities;"[77]

- **Bolivia:** The "lack of regulatory oversight" within Bolivia's 13 FTZs "increases money laundering vulnerabilities"; [78]

- **Colombia:** The 114 FTZs in Colombia are vulnerable to money laundering "due to inadequate regulation, supervision, and transparency";[79]

- **El Salvador:** As of December 2017, the 17 FTZs operating in El Salvador were considered "particularly vulnerable to illicit activity such as TBML and bulk cash smuggling";[80]

- **Morocco:** "Morocco's seven FTZs are regulated by an interagency commission. … Six offshore banks operate in the Tangier FTZ, and all are affiliates of local banks and operate with consolidated controls. The Financial Intelligence Processing Unit (UTRF), the Moroccan FIU, has reported suspicions of money laundering activity through the Tangier FTZ";[81]

- **Panama:** "In January 2017, Panama's National Commission on AML/CFT published its first national risk assessment, which identified FTZs as "high risk" sectors, along with real estate, construction, lawyers, and banks. It is believed that criminals launder money via bulk cash smuggling and trade at airports and seaports, through shell companies, casinos, cryptocurrencies, and through Panama's 12 active FTZs";[82]

- **The Philippines:** "The Philippines Economic Zone Authority (PEZA) oversees 379 economic zones, which are generally adequately regulated. There are also several other special economic zones and free ports that are held privately and do not fall under PEZA oversight. Due to the separate authorities of the security and customs officials monitoring these zones, law enforcement officials face difficulty targeting illicit activity or organizations operating within them";[83]

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75 United States Department of State, *INCSR 2018*, Vol. II, 58.

76 United States Department of State, Bureau of International Narcotics and Law Enforcement Affairs, *International Narcotics Control Strategy Report 2019, Volume II: Money Laundering* (Washington, D.C.: US Department of State, March 2019), 57, https://www.state.gov/wp-content/uploads/2019/04/2018-INCSR-Vol.-II.pdf.

77 United States Department of State, Bureau of International Narcotics and Law Enforcement Affairs, *International Narcotics Control Strategy Report 2020, Volume II: Money Laundering* (Washington, D.C.: US Department of State, March 2020), 59, https://www.state.gov/wp-content/uploads/2020/03/Tab-2-INCSR-Vol-2-508.pdf.

78 United States Department of State, *INCSR 2019*, Vol. II, 61.

79 United States Department of State, *INCSR 2018*, Vol. II, 81.

80 United States Department of State, *INCSR 2018*, Vol. II, 101.

81 US Department of State, Bureau of International Narcotics and Law Enforcement Affairs, *International Narcotics Control Strategy Report 2021, Volume II: Money Laundering* (Washington, D.C.: US Department of State, March 2021), 139, https://www.state.gov/wp-content/uploads/2021/02/21-00620-INLSR-Vol2_Report-FINAL.pdf.

82 United States Department of State, *INCSR 2019*, Vol. II, 151-152.

83 United States Department of State, INCSR 2021, Vol. II, 158.

- **UAE:** The UAE's extensive offshore financial center comprises 45 FTZs, including two financial-free zones. UAE law prohibits the establishment of shell companies and trusts, "however, the operation of financial entities in FTZs that are not identified, regulated, or supervised for financial activity presents a significant gap in regulatory oversight." Therefore, "there is significant opportunity for illicit actors to engage in regulatory arbitrage and avoid the controls and supervision put in place by the Central Bank of the UAE and the regulators of the two financial free zones";[84] The 2021 report found that the UAE's "FTZs host over 5,000 multinational companies and thousands more individual trading companies. FTZ companies are considered offshore for legal purposes. Though UAE law prohibits shell companies and trusts, FTZs present a significant gap in regulatory oversight. FTZs benefit from special tax, customs, and import regimes and are governed by their own regulatory framework. FTZs are often a permissive environment for unidentified or under-supervised entities, such as general trading companies, to operate. Because the FFZs and FTZs are independently regulated, the UAE's federal authorities exercise limited oversight over these jurisdictions."[85]

The U.S. State Department's 2018 Country Reports on Terrorism also identified the FTZs in the Tri-Border Area of Argentina, Brazil, and Paraguay as "regional nodes for money laundering" which were also "vulnerable to terrorist financing."[86]

Another important feature of FTZs is that they do not operate in isolation but are often embedded into expansive international shipping lines, transport lanes, and ports around the world. According to the Financial Accountability and Corporate Transparency (FACT) Coalition, the nature of these globally-connected networks often means that the "illicit trade and associated webs of corruption and criminal networks in one FTZ can have serious ripple effects in other FTZs all around the world," and therefore, collectively, the global web of FTZs creates "a bigger cross-border threat" in terms of enabling criminal activity, terrorist financing and other types of IFFs.[87]

"The very limited degree of involvement and limited authority of customs agencies inside many FTZs render Customs' risk-management-based controls...virtually useless."

--WORLD CUSTOMS ORGANIZATION

For example, "payments for counterfeit products being trafficked through the United Arab Emirates from China and on to Africa and Europe may eventually wind up in Panama where they then — through anonymous shell companies — help to fund other types of illegal activity, be it more illicit trade, other forms of criminality, or terrorist attacks."[88] The Economist Intelligence Unit further explained, "In enticing businesses with the promise of a tax-free environment,

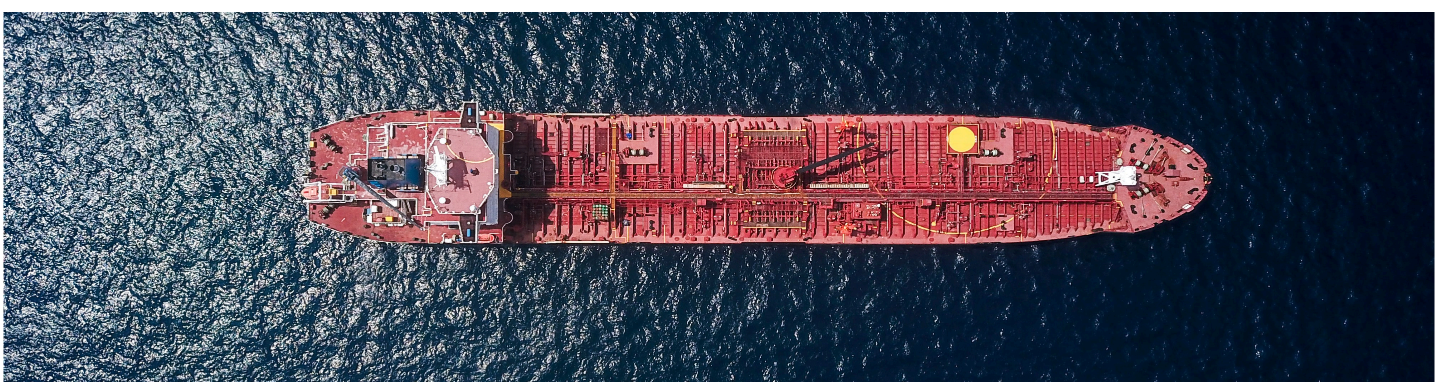

Photo credit: Shaah Shahidh, Unsplash

84 United States Department of State, *INCSR 2018*, Vol. II, 203.

85 United States Department of State, *INCSR 2021*, Vol. II, 190.

86 United States Department of State, Bureau of Counterterrorism, Country Reports on Terrorism 2018 (Washington D.C.: US Department of State, 2019), 187, https://www.state.gov/wp-content/uploads/2019/11/Country-Reports-on-Terrorism-2018-FINAL.pdf.

87 David Luna, "Anonymous Companies Help Finance Illicit Commerce and Harm American Businesses and Citizens: A Need for Incorporation Transparency" Financial Accountability and Corporate Transparency Coalition, May 2019, 10, https://thefactcoalition.org/report/anonymous-companies-help-finance-illicit-commerce-and-harm-american-businesses-and-citizens/

88 Ibid.

with little in the way of regulation, governments across the world have created within their borders unmonitored havens ripe for criminal operations, including those of transnational organised crime networks."[89]

According to the 2010 report by FATF, companies operating out of FTZs in high-risk jurisdictions automatically trigger TBML jurisdictional red flag indicators and therefore warrant further scrutiny by authorities.[90] The report noted:

> "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."[91]

For these reasons, the simple fact that cargo moves through FTZs in designated high-risk jurisdictions can be considered a red flag indicator for TBML activity.[92] Other red flag indicators include goods that are shipped through one or more high-risk jurisdictions "for no apparent economic reason" and goods that have shipping routes that are "inconsistent with normal geographic trade patterns."[93]

"Transaction monitoring of FTZs is currently ineffective because there is no holistic view of customer financial activity. ... Tackling trade-based money laundering effectively requires factoring in the FTZ connection."

-- GARIMA CHAUDHARY, ORACLE FINANCIAL SERVICES[94]

According to Garima Chaudhary, Financial Crime and Compliance Management Specialist at Oracle Financial Services, as goods move through FTZs for the purposes of transshipment, warehousing, re-packaging and re-labelling and storage, sometimes FTZs are used for "no other purpose than money laundering." The multi-layer supply chain systems can be difficult for authorities to monitor, and according to Chaudhury, complex criminal networks can exploit the special status, tax and arrangements in the FTZs, which "can often allow financial criminals to exploit the system with little regulatory oversight."[95]

A handful of FTZs around the world have become particularly notorious among law enforcement for their likelihood to be facilitating TBML. In Southeast Asia, FTZs that also function as casino complexes are of particular concern, such as the Kings Romans casino complex located within the Golden Triangle Special Economic Zone in the Lao PDR side of the Golden Triangle area, where the borders of Thailand, Laos, and Myanmar meet at the confluence of the Ruak and Mekong rivers. Kings Romans, which is owned by a Hong Kong-based company with a 99-year lease, is known as a likely TBML hotspot. In January 2018, the U.S. Treasury Department announced sanctions against Kings Romans, alleging "drug trafficking, human trafficking, money laundering, bribery, and wildlife trafficking."[96] Demonstrating the "lawlessness" of some FTZs, the national Royal Lao Police "report that they are unable to gain access into the SEZ casino area."[97]

89 The Economist Intelligence Unit, "2018 Global Illicit Trade Environment, and, Free Trade Zones: Five Case Studies," 4.

90 Financial Action Task Force, *Money Laundering Vulnerabilities of FTZs*, 33.

91 Ibid, 20.

92 Asia/Pacific Group on Money Laundering, "APG Typology Report on Trade Based Money Laundering," July 2012, https://www.fatf-gafi.org/media/fatf/documents/reports/Trade_Based_ML_APGReport.pdf; PricewaterhouseCoopers, "Goods gone bad: Addressing money-laundering risk in the trade finance system," January 2015, 6-7, https://www.pwc.com/us/en/risk-assurance-services/publications/assets/pwc-trade-finance-aml.pdf.

93 Financial Action Task Force, *Money Laundering Vulnerabilities of FTZs*, 31.

94 Garima Chaudhary, "Free Trade Zones: A Financial Fraud Freeway?" Financial Services Blog, Oracle Financial Services, October 3, 2019, https://blogs.oracle.com/financialservices/post/free-trade-zones-a-financial-fraud-freeway.

95 Ibid

96 US Department of the Treasury, "Treasury Sanctions the Zhao Wei Transnational Criminal Organization," January 30, 2018, https://home.treasury.gov/news/press-releases/sm0272.

97 United Nations Office on Drugs and Crime, Transnational Organized Crime in Southeast Asia: Evolution, Growth and Impact (Bangkok: UNODC, 2019), 21, https://www.unodc.org/documents/southeastasiaandpacific/Publications/2019/SEA_TOCTA_2019_web.pdf.

Similarly, Cambodian SEZs with gambling casinos such as Sihanoukville have been implicated in illicit trade.[98]

In the Americas region, another infamous FTZ is Panama's Colón Free Trade Zone located next to the Panama Canal, through which approximately six percent of global trade passes every year. The Colón Free Trade Zone "has been marked as an area of illicit activity."[99] According to the U.S. State Department, Panama has become an attractive location for money launderers because of its strategic location, dollarized economy, status as a regional financial, trade, and logistics center, and favorable corporate and tax laws. Criminals have been accused of laundering money "via bulk cash smuggling and trade at airports and seaports, and in the active free trade zones" such as the world's second-largest zone, the Colón Free Trade Zone.[100]

Europe's 82 free ports are a "structural problem" and "an emerging threat" to ongoing European efforts to combat money laundering

--THE EUROPEAN COMMISSION

In the Persian Gulf region, the growing number of FTZs in Dubai in the UAE have become well known for their lack of adequate customs oversight and their vulnerability to money laundering activities. Because of the UAE's extensive financial, economic, corporate, and trade activities, including its position as a global leader in oil, diamond, and gold exports, and its strategic geographical location between continents, it has become an FTZ hub, with an estimated 30 to 50 FTZs under its jurisdiction. A 2020 Mutual Evaluation Report from the FATF noted that while the UAE has recently strengthened its legal framework to fight money laundering and terrorist financing, TBML operations using fraudulent invoicing techniques stood out as one of the "main risks" still facing the UAE.[101] A complicating factor, each of the UAE's multiple FTZs has its own commercial regulations, and the Central Bank, the Dubai Financial Services. Authority, and Dubai Customs have limited oversight roles. According to the 2020 FATF report (and similar to the OECD's 2018 report), the very large number of FTZs in

Colón Free Trade Zone, Panama. Photo credit: Roger W (Flickr)

98 Sorn Sarath, "Report: China's new silk road project brings rick of increased illicit trade" Cambodian Journalists Alliance Association, 7 May 2021, https://cambojanews.com/report-chinas-new-silk-road-project-brings-risk-of-increased-illicit-trade/

99 Parliamentary Intelligence-Security Forum, "18th Parliamentary Intelligence-Security Forum," Panama City, Panama, June 29-30, 2021, https://pi-sf.com/forums/panama/.

100 United States Department of State, "2021 Investment Climate Statements: Panama," https://www.state.gov/reports/2021-investment-climate-statements/panama/.

101 Financial Action Task Force, *Anti-money laundering and counter-terrorist financing measures – United Arab Emirates, Fourth Round Mutual Evaluation Report* (Paris: Financial Action Task Force, 2020), 5, http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-uae-2020.html; Mathew T. Page and Jodi Vittori, eds., *Dubai's Role in Facilitating Corruption and Global Illicit Financial Flows* (Washington, D.C.: Carnegie Endowment for International Peace, 2020), 10, https://carnegieendowment.org/2020/07/07/dubai-s-role-in-facilitating-corruption-and-global-illicit-financial-flows-pub-82180; Lakshmi Kumar, "Free-For-All Zones: The Case of Dubai," Global inancial Integrity, August 5, 2020, https://gfintegrity.org/free-for-all-zones-the-case-of-dubai/.

one country is itself a factor that significantly increases the risk of attracting funds with links to crime and terror.[102] From a regional security perspective, there are also concerns about Dubai's FTZs being used to facilitate the shipment of weapons of mass destruction.[103]


Photo credit: Leon Skibitzki, Unsplash

Despite the UAE having significantly strengthened relevant laws and regulations and putting in place a range of committees to improve national coordination and cooperation, the number of suspicious transaction reports (STRs) filed by the FTZs in the UAE has been strikingly low.[104] Further, its limited number of money laundering prosecutions and convictions, particularly in Dubai, is a concern given the country's risk profile. The FATF report found that UAE authorities are not making sufficient use of formal international legal assistance processes to pursue money laundering or the financing of terrorism and proliferation.[105]

The zones have also raised concerns in the European region. Despite having already been identified by the European Commission as "potentially vulnerable to money laundering/terrorist financing risks" in 2017, UK Prime Minister Boris Johnson proposed in 2019 to establish eight new free ports as part of a post-Brexit trade strategy.[106] Drawing on the study, European Justice Commissioner Věra Jourová called Europe's 82 free ports a "structural problem" and "an emerging threat" to ongoing European efforts to combat money laundering.[107] Because FTZs lack the usual stringent checks and oversight exercised by national customs authorities, and the declared value of goods on official invoices only requires "self-declaration" by importers or exporters, the report found there are significant opportunities in the free ports for trade misinvoicing and TBML.

Furthermore, according to the report, precise information on the beneficial owners of companies operating inside the ports "is not available," which means is it very difficult for customs officials or financial investigators to identify those individuals who ultimately own the goods being stored within freeports– a feature which makes the ports even more attractive to individuals and companies engaging in financial crimes as they are able to avoid accountability.[108] Because of these concerns, the commission highlighted free ports as one of seven new issue areas that the EU intends to monitor more closely for money laundering and terrorist financing risks.

The 2019 report followed the 2018 report by the European Parliament, mentioned above, which explained the oversight gaps inherent in freeport regimes: while customs officials are typically obligated to file suspicious transaction reports to the national financial intelligence unit (FIU) about any questionable goods they encounter at regular ports, the goods entering and leaving the free ports are not monitored by customs at all, therefore making suspicious transaction reporting unlikely.[109] The increasing realization of the money laundering risks presented by free ports was acknowledged in the EU's Fifth Anti-Money Laundering Directive, which broadened the scope of entities obliged to maintain AML programs and now explicitly includes expensive works of art handled by free port operators; as an obliged entity, free ports would now be subject to regular independent audits. Based on the directive, since January 2020, free ports within the EU have been subject to the same customer due diligence requirements as, for example, real estate agents or notaries.

102 Financial Action Task Force, *United Arab Emirates, Fourth Round Mutual Evaluation Report,* 27.
103 Andrea Viski and Quentin Michel, "Free Zones and Strategic Trade Controls," *Strategic Trade Review* 2, no. 3 (2016): 36, http://www.str.ulg.ac.be/wp-content/uploads/2016/10/Free-Zones-and-Strategic-Trade-Controls.pdf.
104 Financial Action Task Force, United Arab Emirates, Fourth Round Mutual Evaluation Report, 10.
105 Ibid, 12.
106 European Commission, *Report from the Commission to the European Parliament,* 1, Footnote 7; Jasper, Burden, and Morison, "U.K. Names Eight Free Ports."
107 Ya Chun Wang, "Free ports are money laundering threat, says Commission: Incoming UK Prime Minister Boris Johnson is a big fan," *Politico.eu*, July 24, 2019, https://www.politico.eu/article/free-ports-are-money-laundering-threat-says-commission/.
108 European Commission, Report from the Commission to the European Parliament, 5-6.
109 European Parliamentary Research Service, *Money laundering and tax evasion in free ports,* 13.

National authorities had already adopted more stringent requirements for some of the more high profile FTZs in Europe, such as Le Freeport in Luxembourg, which in 2015 brought the free port under national AML law and required the collection of beneficial ownership data on companies that stored goods. Since then, owners of expensive artwork stored in free ports have not been allowed to use offshore companies, trusts, lawyers, or galleries to shield their ownership. The changes reportedly drove away between 20 and 30 long-standing clients at Le Freeport; many were offshore companies based in Hong Kong which "decided on other free ports with more discretion."[110]

Similarly, Swiss authorities implemented a set of strengthened AML rules aimed at international trade and FTZs in 2016. Changes included "making serious tax offenses a predicate offense to money laundering,[111] empowering customs to monitor the entry and exit of goods in the zones, setting a 6-month limit on how long goods can be stored and amending multiple AML laws and criminal codes."[112]

However, many other free ports and FTZs outside the EU continue to exercise less stringent oversight, and much more could be done to address this. One recommendation has been to sanction those FTZs that have been identified as high risk. In a 2019 briefing before the US House of Representatives' Commission on Security & Cooperation in Europe, transnational crime expert David Luna advised:

> It is important to consider sanctioning those free trade zones that are risky, that are not really being as transparent, or enforcing, implementing, anti-illicit trade, anti-corruption, anti-money-laundering regulations and laws to help combat the cross-border issues of illicit trafficking."[113]

Like sanctions against individuals, companies, organizations, and countries, sanctions against FTZs could cut them off from the international trade and/or financial systems until they meet minimum standards. In October 2020, RUSI examined the key risk factors that render FTZs vulnerable to illicit trade and financial crime with an in-depth examination of FTZs in four countries: Morocco, Panama, Singapore, and the UAE. The common risk factors identified in the zones included:

Changi Airfreight Center, Singapore, Photo by Guowen Wang via Flickr

110 Anny Shaw, "European Commission president Jean-Claude Juncker must close tax loopholes at Luxembourg freeport, MEP says," *The Art Newspaper*, January 31, 2019, https://www.theartnewspaper.com/news/european-commission-president-jean-claude-juncker-must-close-tax-loopholes-at-luxembourg-freeport-mep-says; Jennifer Rankin, "Inside the Luxembourg free port storing riches for the super-wealthy: Depending on who you speak to, Le Freeport is a high-security storage facility or a money-laundering risk," *Guardian*, July 6, 2019, https://www.theguardian.com/business/2019/jul/06/inside-the-luxembourg-free-port-storing-riches-for-the-super-rich.

111 This is notable because previously under Swiss law, only felonies, that is offenses with a custodial sentence of more than three years, could be prosecuted for money laundering, and tax offenses were not classified as felonies; the 2016 update exempted serious tax offenses despite this.

112 Mahamadi, "UK Free Ports Plan Risks."

113 David Luna, Comments to the Commission on Security and Cooperation in Europe, *Shady Shipping: Understanding Trade-Based Money Laundering*, House of Representatives, 116th Cong., 1st sess., United States Congress, May 24, 2019, 16, https://www.csce.gov/sites/helsinkicommission.house.gov/files/unofficial-transcript/0524%20Shady%20Shipping%20-%20Understanding%20Trade-Based%20Money%20Laundering%20Scrubbed.pdf.

- "The lack of consistent international standards and incentives for the policing of goods that pass through FTZs in transit;
- "Inadequate understanding of FTZ-related criminal risks in general and financial crime risks specifically, including at the stage of planning and approving the establishment of an FTZ;
- "Uncertainty in the division of responsibility for the monitoring, governance, and regulation of FTZs, including limited information sharing and failure to involve customs agencies in FTZ-level risks assessment;
- "The absence of credible monitoring of FTZ administrators and users, as well as the resulting gap in enforcement;
- "The lack of proportionate sanctions and AML/CTF supervision of FTZ-based businesses that would take account of the risk profile and volume of FTZ activities;
- "Limited cooperation between law enforcement and the private sector."[114]

These examples highlight the broader concerns about the serious shortcomings in standards, risk awareness, and oversight that plague many FTZs around the world. Given the widespread nature of such concerns, it is also alarming that a growing quantity of global trade is moving through the world's increasing number of FTZs. While the WTO estimated that the total value of global goods trade in 2019 was close to US$20 trillion, the UNOCD reported that about 90 percent of all goods trade is conducted via maritime containers, of which more than 500 million are shipped annually.[115] However, according to UNODC, less than two percent of all containers are inspected each year, in part due to the extra time and costs associated with inspections.[116]

The original intent was to apply special tax treatment to the goods moving in and out of the zones, but over time this treatment has come to be erroneously applied to the activities of companies operating in the zones as well.

Because physical inspection of containers is not an answer to addressing TBML, an emerging consensus is that requiring adequate paper trails and improving the degree information sharing among relevant parties is the most effective approach. Included in this approach is the increased use of IT tools that enable multiple agencies to better share access to information about the beneficial owners of goods and to more effectively identify falsified customs invoices. But even more than physical inspections and new IT data-sharing technologies is the issue of securing the political will among critical constituencies to achieve cooperation in information sharing.

This also includes the whole range of actors involved in trade financing. Because most exporters prefer to be paid upfront, importers typically will arrange trade financing prior to finalizing trade transactions. The process of securing trade financing typically includes items such as letters of credit and various types of guarantees or insurance obtained by both importers and exporters and is usually provided by intermediaries such as banks, export credit agencies, and insurers. According to the WTO, approximately 80 to 90 percent of world trade is dependent on trade finance, mostly of a short-term nature.[117] In an important development in recent years, many banks which are active in trade finance have begun adopting extensive AML/CFT regulatory controls to address the problem of TBML and are being encouraged to do so in new guidance issued by the FATF and the Egmont Group, an international organization of various countries' financial intelligence units, as well as by the EU-wide European Banking Authority.[118]

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114 Anton Moiseienko, Alexandria Reid, and Isabella Chase, Improving Governance and Tackling Crime in Free-Trade Zones (London: Royal United Services Institute, October 2020), 47, https://static.rusi.org/20201012_ftzs_web_2.pdf.

115 World Trade Organization, "Trade set to plunge as COVID-19 pandemic upends global economy," Press Release, Geneva, April 8, 2020, https://www.wto.org/english/news_e/pres20_e/pr855_e.htm; United Nations Office on Drugs and Crime, "Container Control/The Global Container Control Programme," Vienna, 2019, https://www.unodc.org/ropan/en/BorderControl/container-control/ccp.html.

116 Ibid.

117 World Trade Organization, "Trade finance," Geneva, accessed April 5, 2021, https://www.wto.org/english/thewto_e/coher_e/tr_finance_e.htm; Chris Murphy, "Trade Finance," *Investopedia.com*, July 23, 2020, https://www.investopedia.com/terms/t/tradefinance.asp; Marco Carbajo, "5 Facts You Need to Know About Trade Finance," *The Balance*, December 9, 2019, https://www.thebalancesmb.com/trade-finance-explained-5-facts-you-need-to-know-3953592.

118 John Basquill, "Authorities issue fresh guidance on trade finance money laundering risks," Global Trade Review, March 17, 2021, https://www.gtreview.com/news/global/authorities-issue-fresh-guidance-on-trade-finance-money-laundering-risks/.

However, much of global trade finance is provided by other types of non-bank financial institutions (NBFIs) and designated non-financial businesses.

Organized criminal networks engaged in TBML tend to "leave footprints" across many organizations – all of which stand to benefit from sharing that intelligence with each other.

Based on interviews with more than 60 individuals in the UK, Europe, North America, Middle East, and Singapore, the Centre for Financial Crime and Security Studies at RUSI found that getting incentives better aligned among these disparate stakeholders is key.[119] The interviews showed that although each community experiences TBML activities in different and limited ways, one common denominator is that organized criminal networks engaged in TBML tend to "leave footprints" across many organizations, all of which stand to benefit from sharing that intelligence with each other in order to get a bigger and more comprehensive picture about who is trading what with whom.[120] Such a more comprehensive approach to information sharing across all of the key actors involved in international trade – from banks, export credit agencies, and insurers to customs, tax, law enforcement agencies, FTZ administrators, FIUs and shipping companies – will be necessary for strengthening efforts to reduce TBML activity generally.

Photo credit: Kristijan Arsov, Unsplash

However, even as all of these actors take steps to improve their adherence to AML/CFT regulations and expand information-sharing practices, another question is if these regulations and practices will also apply equally to companies operating inside the world's FTZs. Unfortunately, the answer to this question is still unclear. To better address the need for improved AML/CFT oversight within FTZs, RUSI has advocated applying a broader, "ecosystem" approach to information sharing.[121] Because companies often find it difficult to distinguish between low-risk and high-risk FTZs, in April 2021, RUSI launched a freely available online risk assessment tool.

119 Jonathan Draper, "Addressing the Abuse of Trade for Money Laundering Purposes," Commentary, Royal United Services Institute (RUSI), October 2019, https://rusi.org/commentary/addressing-abuse-trade-money-laundering-purposes.
120 Ibid.
121 Anton Moiseienko, et al, "Free Trade Zones and Financial Crime – A Faustian Bargain?" Centre for Financial Crime and Security Studies, Royal United Services Institute, London, Commentary, 5 November 2019, https://rusi.org/commentary/free-trade-zones-and-financial-crime-faustian-bargain.

The tool is intended for use by banks, insurance companies, shipping lines, freight forwarders, and others. It asks users to rate 11 key risk factors common to FTZs, provides a framework for their assessment, and produces a numerical risk score for any FTZ. The score could be used by compliance and investigation professionals as a first step in assessing the risk profile of a particular FTZ. Because most investigators are using broader national risk profiles, the new tool by RUSI could supplement these by providing a more accurate risk assessment of individual FTZs within countries.[122]

Similarly, Oracle Financial Services has proposed that the multiple agencies and companies with an interest in improved oversight of FTZs establish "centralized investigation hubs" that could speed up investigations and boost investigator productivity with advanced AML technology.[123] Because financial criminals register themselves under multiple names and addresses, such IT systems can improve the capacities of investigators to "connect the dots" in their data and uncover hidden relationships and patterns within broader sets of transactions being analyzed. Typically, many AML programs only factor internal information (such as the customer, Bill of Lading, and related documents) for monitoring and investigation, but detecting illicit financial activity often requires factoring in several other types of external sources of information as well, such as comparisons of customer activity with overall FTZ customers of a similar business nature, more detailed company information, actual vessel routes, etc.

Therefore, Oracle's approach suggests that comprehensive investigations should include additional information beyond any one institution's purview to build a sufficiently broad-based set of data with which to cross-reference customer activities. Such a broader view of risk indicators for Know Your Customer (KYC) and AML due diligence within FTZs could include factors such as the following:

- Individuals or companies linked with several other companies
- Individuals owning and operating more than one company at the same time in the same location
- Companies shipping to just one country
- Direct operations in an FTZ
- Companies and individuals with the same family ties
- Companies registered with incorrect addresses
- Companies doing business in known high-risk geographies
- Inconsistent shipping routes/changes in shipping routes from the Bill of Lading
- Other types of external network data[124]

Examples of such additional types of external information that could be used to supplement internal information include:

- Businesses operating in FTZ - names, addresses, phone numbers, and websites
- Trend reports of the amounts of goods/services received and shipped in FTZs
- Financial institutions (and their principal officers) serving the businesses in the FTZ
- Shipping lines that transport goods/services from the port or ports serving the FTZ
- Products/goods brands sold by each company operating in the zones
- Data on the global supply chains of companies operating in FTZs, from manufacturers and buyers to shipping and logistics firms.[125]

122 Royal United Services Institute, "RUSI Develops Free-Trade Zone Risk Assessment Tool," Centre for Financial Crime and Security Studies, London, April 26, 2021, https://rusi.org/rusi-news/rusi-develops-free-trade-zone-risk-assessment-tool.
123 Garima Chaudhary, "Free Trade Zones: A Financial Fraud Freeway?"
124 Ibid.
125 Ibid.

5 LACK OF COMPLIANCE WITH THE REVISED KYOTO CONVENTION

One of the most important factors enabling FTZs to continue escaping greater oversight is the widespread notion that the zones have some type of special "extraterritorial" qualities, i.e., they in some way exist outside of the regular laws and rules of countries. Calling this a "misconception," the deeply problematic nature of this notion was underscored in a 2019 report by the WCO about why and how national customs authorities have come to exercise such little oversight of the activities going on inside FTZs around the world.[126] Put simply, the popular notion of "extraterritoriality" has been stretched far beyond its original meaning. The original intent was primarily about applying a special lower tax on the goods moving in and out of the zones, but over time this special tax treatment has come to be erroneously extended to include the activities of companies operating in the zones as well. However, according to the WCO, the activities of companies operating within the zones should still be regulated by national customs authorities.

The only international convention that formally defines and procedurally regulates FTZs is the International Convention on the Simplification and Harmonization of Customs Procedures, known as RKC. The RKC is one of the flagship international conventions of the WCO and is considered a blueprint for modern customs procedures aimed at developing predictable and transparent customs procedures based on the use of IT, risk management, and a coordinated approach with other governmental agencies. As of November 2021, of the 183 WCO Member states, the RKC currently has 129 Contracting Parties but far fewer adherents.[127]

The RKC consists of three parts: the text, a General Annex with 10 Chapters, and 10 Specific Annexes. The entire General Annex is binding on the Contracting Parties, and no reservations are possible with respect to its implementation. But Contracting Parties may voluntarily accept one or more of the Specific Annexes as well as submit reservations to the Recommended Practices that have been developed by the WCO as guidelines to help zone administrators implement the Standards and Recommended Practices. Of critical importance for the concerns related to FTZs is Chapter 2 of the Specific Annex D (SAD2) of the RKC, which states that "goods" located in FTZs are regarded as being outside the customs territory solely with respect to import duties/taxes levied – but the zones themselves are still part of the territory of the country in which the zone is located, and the national customs authorities still have oversight over the zones.

National customs authorities should have oversight over companies' activities within the zones.

--WORLD CUSTOMS ORGANIZATION

Unfortunately, very few countries have become Contracting Parties to the RKC's SAD2. As of November 2021, of the 129 countries which have become Contracting Parties to the RKC, only 29 are Contracting Parties to SAD2. And of these, only 23 are fully adhering to SAD2, while six are adhering to SAD2 with reservations concerning several of the Recommended Practices.[128] Therefore, the overwhelming majority of countries in the world which currently host FTZs have not yet voluntarily agreed to become Contracting Parties to the RKC and this critical annex, SAD2.

SAD2 is particularly relevant because it lists 21 Standards covering a wide range of customs procedures related to operations in FTZs. For example, Standard 4 stipulates that national customs authorities "shall have the right to carry out checks at any time on the goods stored in FTZs."[129] Additionally, according to the WCO report, Standard 4 is to be

126 Omi, "'Extraterritoriality' of Free Zones," 21.

127 World Customs Organization, "The Revised Kyoto Convention now has 129 Contracting Parties following the accession of Kyrgyzstan, November 19, 2021, http://www.wcoomd.org/en/media/newsroom/2021/november/the-revised-kyoto-convention-now-has-129-contracting-parties-following-the-accession-of-kyrgyzstan.aspx.

128 World Customs Organization, "International Convention on the simplification and harmonization of Customs procedures: Position as Regards Ratifications and Accessions as of 19 November 2021," http://www.wcoomd.org/-/media/wco/public/global/pdf/about-us/legal-instruments/conventions-and-agreements/revised-kyoto/pg0316ea.pdf?la=en.

129 World Customs Organization, "Specific Annex D" of the Revised Kyoto Convention, http://www.wcoomd.org/en/topics/facilitation/instrument-and-tools/conventions/pf_revised_kyoto_conv/kyoto_new/spand.aspx.

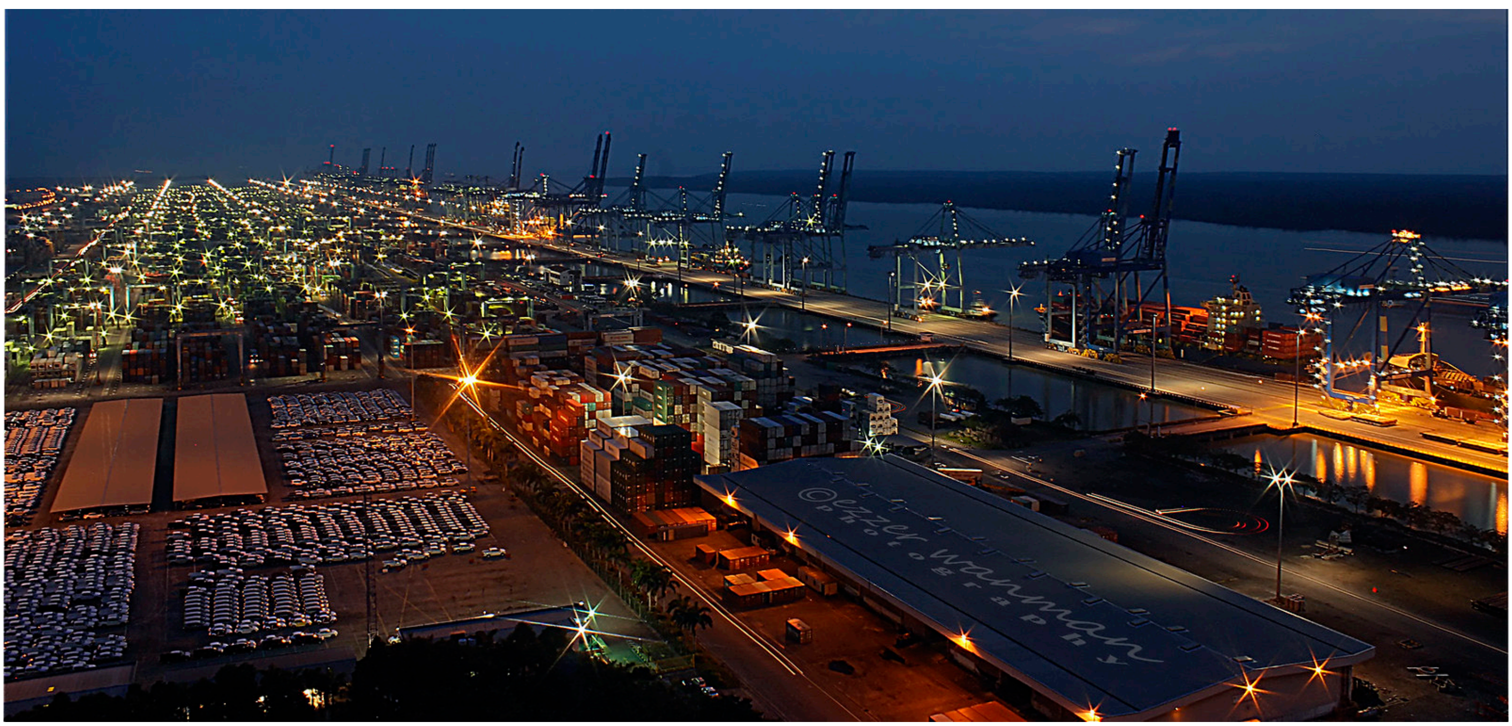
interpreted together with Standard 3, which states that "the Customs shall lay down the arrangements for Customs control, including appropriate requirements as regards the suitability, construction, and layout of free zones."[130] The engagement of customs authorities from the early stages in developing an FTZ's concept is necessary to ensure safety, security, efficiency, and trade facilitation within the zone.

But the notion of extraterritoriality of the zones is in direct conflict with SAD2 and the idea that national customs authorities ought to exercise oversight of the zones. A further complicating problem is that the widespread popularity of extraterritoriality has led several countries to pass legislation and adopt regulations that go in the opposite direction as the RKC and SAD2 by codifying freedom from customs oversight for their FTZs. For example, countries have adopted laws or regulations that state that their FTZs are "outside the customs territory" – with "outside" referring to not just the goods within the zones but to the entire zones themselves and the activities that occur within the zones.

There is a popular notion of FTZs as an "extraterritorial free-area" which is free from, and where there is a rejection of, usual customs controls and oversight.

The widespread nature of this misconception was highlighted in a WCO survey of 61 national customs authorities about their ability to regulate FTZs, which found that in several countries, customs officers have no authority to obtain periodical reports from companies operating in their FTZs (20 percent of respondents) and have no authority to audit companies inside FTZs (20 percent of respondents). Today, in several countries, government authorities cannot even enter FTZs without obtaining prior approval from an FTZ authority or cannot enter FTZs without concrete suspicion of illicit trade. In one case, the national customs agency has no authority to revoke companies' rights to operate in FTZs, including those accused of perpetrating smuggling activities within FTZs.[131]

The increasing popularity of the notion of FTZs as extraterritorial spaces has become a major problem. However, such laws and regulations that have codified extraterritoriality can be amended and overridden with new ones. For example, after several scandals involving its FTZs, Switzerland's government amended its Customs Act in 2007 to explicitly undo this concept of an "extraterritorial free-area" and redefine its FTZs as being "part of the Customs territory."[132]



The Westport Free Zone, Malaysia, Photo by Ezzer Wanman via Flickr

130 Ibid.

131 Omi, *Extraterritoriality' of Free Zones,* 22.

132 Jean-Robert Gisler, "Switzerland addresses the traffic in cultural goods," *WCO News,* June 2016, https://mag.wcoomd.org/magazine/wco-news-80/switzerland-addresses-the-traffic-in-cultural-goods/.

Similarly, since January 2020, the strengthened enforcement rules of the EU's Fifth Anti-Money Laundering Directive (5AMLD) have been in force inside the EU's 82 free ports. Under 5AMLD, traders of artwork and those acting as intermediaries in the trade of artwork, including free ports, are now subject to AML rules and oversight. This means they are now required to conduct customer due diligence checks and issue suspicious activity reports (SARs) whenever transactions exceed €10,000 or more.[133] However, while 5AMLD represents an important step forward, these AML obligations must be extended to other types of goods if free ports are to be effectively protected from criminal activity. And, of course, there is a need for such rules to be adopted for FTZs worldwide, not just in the European Union.

Also encouraging are the rulings of some national courts that have challenged the notion of extraterritoriality. For example, certain rulings by courts in the UAE, Turkey, Singapore, and Malaysia have reaffirmed the responsibility of states to protect the IPRs of trademark and patent holders from violations by counterfeiters – even those operating inside of FTZs. For example, in the case of the Mersin Free Zone, the Turkish high court confirmed that FTZs remain within the country's territorial boundaries and that no immunity is given by the laws applying to FTZs with respect to the use of trademarks.[134] Similarly, in case of the Westport Free Zone in Malaysia, the court determined that FTZs are not excluded from the customs authority's powers of enforcement of the Trade Marks Act/Trade Description Act just because it is incorrectly "deemed to be outside Malaysia."[135] And in Singapore, state courts recognized the right of the customs authorities to inspect cargo within FTZs with the 2017 conviction of cigarette and bulk cash smugglers who attempted to falsely label cargo as "machinery parts and accessories" in the Changi Airfreight Centre.[136]

Some national courts that have challenged the notion of extraterritoriality for FTZs.

133 Hiba Mahamadi, "UK Free Ports Plan Risks Influx of Dirty Money, Say Experts."

134 Dobson, "Balancing trade facilitation and control," 8..

135 Ibid.

136 International Chamber of Commerce, "Controlling the Zone: Balancing Facilitation and Control to Combat Illicit Trade in Free Trade Zones – A 2020 Update," Business Action to Stop Counterfeiting and Piracy, Paris, 2020, page 28, https://iccwbo.org/content/uploads/sites/3/2020/12/2020-bascap-report.pdf.

6 ANALYSIS

This report has documented the history of FTZs in the global trading system and reviewed many recent trends and features of the operations of FTZs. It has documented the concerns about how the lack of effective customs oversight inside many FTZs is being exploited for the purposes of counterfeiting, infringements on IPRs, smuggling, and TBML and reviewed the reasons for the widespread lack of oversight by national customs authorities. Given the challenges identified, this section analyses the current context and reviews new guiding principles, best practices, and recommendations for improving customs oversight of the world's FTZs.

Fortunately, many of these trends and features with FTZs, which contribute to the creation of "blind spots" for customs and law enforcement, are beginning to give way. For example, the longstanding belief that increased customs oversight and streamlined economic efficiency in the FTZs cannot go together is finally being questioned. This change was reflected in a 2019 report by McKinsey & Company, which noted that the FTZs can provide economic benefits without sacrificing the safety and security of trade and that there are important roles for customs authorities both in terms of regulating and facilitating trade in the zones.[137]

The WCO also elaborated on this concept in a 2020 report by detailing ways FTZ administrators and national customs authorities could deepen their collaboration on developing and administering FTZs without sacrificing efficiency. These include: ensuring customs authorities have a role in approving the companies Allowed to operate within FTZs and their allowed activities and ensuring that customs is involved in due diligence and compliance record checks at the company approval stage.[138]

However, despite the new thinking on this issue, there are still no comprehensive international frameworks that establish a series of standardized rules or governing regulations for FTZs regarding allowable activities, information, or data sharing. In the absence of such international frameworks, it will be up to individual countries to further strengthen oversight of their FTZs. It will also be up to individual countries to step up their advocacy at the international level to join with others in calling for the establishment of a global agreement on the regulation of FTZs.

Although there is not yet any international agreement or treaty on the regulation of FTZs, the growing concerns about the lack of oversight in FTZs around the world documented in this report have led to an emerging body of "soft law" in recent years – numerous sets of guidelines, recommendations and voluntary codes of conduct produced by leading

There are still no comprehensive international frameworks that establish a series of standardized rules or governing regulations for FTZs.

137 Jonathan Davis, et al, "How customs agencies can help special economic zones succeed," McKinsey & Company, August 21, 2019, https://www.mckinsey.com/industries/public-and-social-sector/our-insights/how-customs-agencies-can-help-special-economic-zones-succeed
138 World Customs Organization, "Practical Guidance on Free Zones", Brussels, December 2020 http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/facilitation/activities-and-programmes/free-zone/wco-fz-guidance_en.pdf?la=en

governments and international organizations and institutions. These guidelines and recommendations offer useful steps for governments to consider and indicate a path forward for countries worldwide to cooperate in addressing the problems with FTZs increasingly.

For example, in 2008, the EU established a series of defining terms under the Union Customs Code that set out the common requirements for FTZs, which defines and treats the zones as being inside the customs territory, not separate from it, and subject to customs controls. Specifically, Article 243 in Section 3 ("Free zones") states that "Member States may designate parts of the Customs territory of the Union as free zones" and that "Persons, goods, and means of transport entering or leaving free zones may be subject to Customs controls."[139] Furthermore, Article 244 specifies that customs authorities are granted the right to refuse or restrict certain activities in the zones for safety and security considerations or national laws.[140]

In 2010, FATF produced a compilation of best practices and recommendations for how oversight could be improved in FTZs.[141]

Countries should sign and ratify the Revised Kyoto Convention (RKC) and particularly commit to Chapter 2 of the Specific Annex D (SAD2), which reiterates that FTZs are still part of the territory of the country in which the zone is located, and over which the national customs authority has oversight.

In 2013, BASCAP recommended the integration of national customs authorities into automated systems run by FTZ administrators. BASCAP has also called for the WCO's 2005 SAFE Framework of Standards to Secure and Facilitate Global Trade to be applied to activities within FTZs.[142] While the SAFE Framework does not explicitly refer to FTZs, it contains an already established set of global recommendations designed to strengthen the effectiveness of customs controls, with emphasis on the threat posed by terrorism and organized crime across all international trade.[143] As of August 2020, 171 states had signaled their intention to apply the SAFE Framework. However, it remains unclear how many signatories will apply the recommended principles within their FTZs.[144]

As a follow-up to its 2013 report on FTZs, in 2020, the ICC's BASCAP published an updated set of recommendations, including steps to address a series of identified needs:

- The need to strengthen relationship between customs authorities and FTZs;
- The need to empower national customs authorities;
- The need to ensure government allow targeted data sharing between customs and the private sector;
- The need to strengthen national government adherence to international conventions and implementation of recommendations;
- The need to enhance the use of Certificates of Origin in international trade;
- Specific recommendations for the WCO; the WTO; National Governments; and Free Zone Operators.[145]

In 2015, the OECD Task Force on Countering Illicit Trade was established to address the governance gaps that criminal

139 European Parliament, "Regulation (EU) No 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code" (2013 modernized version on the 2008 code), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0952&rid=1.

140 Ibid.

141 FATF, 2010, 27-29.

142 International Chamber of Commerce, 2013, page 34.

143 In 2005, the WCO established its SAFE Framework of Standards to Secure and Facilitate Global Trade (SAFE Framework) to bring a connected, system-based set of controls to the entire supply chain. The SAFE Framework, a voluntary partnership between national customs authorities, border agencies and private companies, has been adopted by 171 countries to date. A cornerstone of the program is the Authorized Economic Operator (AEO) status that WCO grants to companies that are in compliance with WCO or equivalent supply chain security standards. Today more than 70 countries have operational AEO programs in place while another 30 countries are in the process of implementing the instrument. The SAFE Framework has proven to be highly effective at deterring criminal activities across territories. See: World Customs Organization, SAFE Framework of Standards to Secure and Facilitate Global Trade (SAFE Framework), Brussels, http://www.wcoomd.org/en/topics/facilitation/instrument-and-tools/frameworks-of-standards/safe_package.aspx.

144 World Customs Organization, "Members who have expressed their intention to implement the WCO Framework of Standards to Secure and Facilitate Global Trade – As of 05 August 2020," http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/facilitation/instruments-and-tools/tools/safe-package/wco-table-intention-to-implement-the-fos.pdf?la=en.

145 International Chamber of Commerce, 2020, 33-38.

entrepreneurs successfully navigate to operate across borders. The Task Force meets regularly to focus on different facets of illicit trade. In 2017, the OECD High-Level Risk Forum called on the Task Force to develop a draft set of guidance on countering illicit trade informed by inputs from FATF, the WCO, and the WTO Secretariats and in consultation with over 200 stakeholders. And in 2018, the Task Force finalized its "Recommendations on Enhancing Transparency in Free Trade Zones," which includes a "Code of Conduct for Clean Free Trade Zones."[146] This Code was designed as the basis for a risk management toolkit to help promote better oversight practices in FTZs and reduce illicit trade. It was adopted in 2019 by the OECD Council.

Photo By U.S. Customs and Border Control

The OECD Task Force recommendations include:

- **Customs Access:** Provide unconditional access to the jurisdiction's customs and law enforcement agencies where they are established to carry out unobstructed, ex officio enforcement checks of operators in support of investigations of violations of applicable law.
- **Access to Information:** Ensure that economic operators active in the FTZ are required to grant access to their detailed digital records upon request of the FTZ authority, the customs authorities, or any other competent public authority in the jurisdiction where the zone is established. FTZ Administrations should appoint a dedicated point of contact with the necessary skills and resources to respond effectively to such requests for information from public authorities and to lead due diligence and compliance verifications on companies and persons operating within FTZ.
- **Information Exchange:** Encourage international cooperation in exchanging law enforcement information (financial and administrative) and consult with appropriate authorities and affected industries in investigations and other legal proceedings concerning specific cases of misuse of FTZ related to illicit trade.
- **Record Keeping:** Ensure that economic operators active in the FTZ maintain detailed digital records of all shipments of goods entering and leaving the zone, as well as all goods and services produced within it, sufficient to know what is inside the zone at any given time.
- **Payments:** Deter cash payments for any commercial or financial transaction of the economic operators active in the FTZ occurring inside or originating from the FTZ, and for large cash transactions, document the details and report to the customs authority.
- **Awareness:** Promote awareness amongst the business community, including all relevant stakeholders, from shipping lines to logistic companies, shipping agents, custom brokers, and freight forwarders (i.e., major intermediaries including shipping agents, freight forwarders, customs brokers, and logistics companies) to understand the major risks related to FTZs.
- **Public-Private Partnerships:** reinforcing awareness efforts to encourage the business community that makes use of FTZs, or that finances operators within FTZ to refrain from doing business in FTZ that are not compliant with these recommendations.[147]

146 Organization for Economic Cooperation and Development, "OECD Recommendation on Countering Illicit Trade: Enhancing Transparency in Free Trade Zones," Paris, March 2019, https://www.oecd.org/governance/risk/recommendation-enhancing-transparency-free-trade-zones.htm.
147 Ibid.

Since January 2020, the strengthened rules in the EU's 5AMLD have come into force, requiring the EU's 82 free ports to now conduct customer due diligence checks and issue suspicious activity reports (SARs) whenever transactions exceed €10,000 or more.[148]

Lastly, in December 2020, the WCO published its "Practical Guidance on Free Zones," consisting of seven core elements, many of which address the key problems with FTZs identified in this report:

- The need to address the territoriality aspect of Free Zones (FZs);
- The need for full customs involvement in FZs;
- The need for customs involvement in the company approval process as outlined in the WCO's "Authorized Economic Operator" (AEO) concept;
- The need for regularized and systematic reporting to customs authorities and the use of data and IT systems;
- The need for customs authorities to be able to carry out audits in FZs;
- The need for customs control and surveillance, including authority for customs authorities to seize illegal goods in FZs, to conduct on-site checks inside FZs, and the use of technology for inspections in FZs;
- The need for enhanced cooperation on multiple levels.[149]

While these various national, regional, and international efforts reflect an emerging body of "soft law," the reality is that the vast majority of them are only voluntary in nature and are not legally binding. It is critically important that international efforts are supported to raise this body of recommendations and guidelines to the next level where they can become established in international law and enforced by international institutions such as the WTO and the WCO.

Private Sector Initiatives

The major global private industry associations of FTZs are aware of the growing scrutiny that FTZs are facing and have been responding by developing their own voluntary codes of conduct, possibly as preemptive measures to slow the momentum on what is likely to lead to increased regulatory oversight in the future.

World Free Zones Organization

The World Free Zones Organization (WFZO), established in 2014 with 574 members in 125 countries, launched its "Safe Zone certification program" in July 2020, which is a voluntary program based on self-assessments by zone operators and companies that get vetted by independent third parties. The WFZO has implied that successful certification by its Safe Zone program would enable zones to also be in compliance with the OECD's "Code of Conduct for Clean Free Trade Zones." However, because details of the program's precise certification criteria have not been made publicly available[150], officials governing the OECD's Code of Conduct have denied that certification by the WFZO Safe Zone program would necessarily enable zone operators to be in automatic compliance with the OECD's Code of Conduct.[151]

148 Hiba Mahamadi, "UK Free Ports Plan Risks Influx of Dirty Money, Say Experts."

149 World Customs Organization, 2020.

150 World Free Trade Zones Organization, "Safe Zone Certification Program: White Paper, " Dubai, June 2020. On p.10, the White Paper listed the seven different areas or sets of questions/criteria upon which companies are expected to self-report, but the precise questions/criteria were not listed. GFI requests for futher details unanswered. See: https://www.google.com/url?sa=D&q=https://certificationshub.com/download-brochure/1%23:~:text%3DThe%2520World%2520FZO%2520has%2520built,to%2520clients%252C%2520partners%2520and%2520stakeholders&ust=1662832440000000&usg=AOvVaw0GNprMemghI4XKB59aznYX&hl=en&source=gmail

151 GFI interview with Mr. Piotr Stryszowski, Senior Economist, Directorate for Public Governance, OECD, and lead author of OECD's Code of Conduct for Clean Trade Zones ," August 25, 2020.

Similarly, the WFZO also implied that successful certification by its Safe Zone program would enable companies to be in compliance with the criteria to meet the WCO's coveted Authorized Economic Operator (AEO) status However, the WCO clarified that companies complying with the WFZO's certification program does not lead to automatic qualification for the WCO's AEO status.[152]

World Free & Special Economic Zones Federation

The World Free & Special Economic Zones Federation (FEMOZA), established in 1999 and comprised of FTZ operators and companies in 132 countries, announced in May 2020 that it is cooperating with its partner, FEMOZA Management Company (FEMAC), to develop a "Best Practice Management System for SEZs," but it has not yet publicly disclosed its contents.[153] Similar to the case with the WFZO's Safe Zone certification program, it is difficult to know to what degree the FEMOZA Best Practice Management System for SEZs would be in compliance with the high standards set by the OECD and WCO regarding improved national customs oversight of FTZs.

152 Email correspondence between GFI and Ms. Sylvie Degryse, Communications and Information Officer, World Customs Organization, August 27, 2020.

153 Francisco Litvay, "FEMOZA Cooperates with FEMAC to Provide Professional Support for SEZs," FEMOZA Management Company, Geneva, May 7, 2020, https://femac-sez.com/femoza-partnership-release/.

7 GFI RECOMMENDATIONS

This report has documented the growing international concerns about the lack of adequate oversight in the world's increasing number of FTZs, and how this facilitates the global problem of IFFs.

Based on this research and analysis, GFI offers the following recommendations directed at international organizations and national governments as steps that we believe are necessary to improve the oversight of FTZs while still allowing them to promote international trade effectively:

1. **DEEPEN INTERNATIONAL COOPERATION ON IMPROVING OVERSIGHT OF FTZs:** The WCO should convene an international conference with the participation of key stakeholders such as the WTO, ITC, UNODC, UNCTAD, INTERPOL, and the OECD that is designed to address the issues highlighted in this report. At such a conference, the parties must establish a clear international definition of the zones and a taxonomy that allows the world's FTZs to be identified, categorized, and counted. Critically, these parties must also take concrete steps towards an international agreement on the regulatory standards necessary to ensure the zones are not used for illicit trade, smuggling, and TBML, and seek agreement on expanded information-sharing protocols.

2. **ESTABLISH NATIONAL "BENEFICIAL OWNERSHIP" (BO) REGISTRIES THAT INCLUDE COMPANIES OPERATING IN FTZs:** GFI recommends that all countries should: establish a definition of BO and what constitutes effective/ultimate control; ii) pass legislation that requires the collection of BO information at the establishment of legal entities and arrangements (this should include trusts) as well collect the same information for entities and arrangements that have already been established; iii) establish a public BO registry; and iv) require BO information for all companies operating within the FTZs located within their jurisdictions;

3. **ESTABLISH AN UPDATED AND PUBLIC WCO DATABASE ON FTZs:** The WCO should create a database that provides information on: i) how many zones are operating in each country; ii) the types of zones operating in the country; iii) how many companies are operating in each zone; and iv) information regarding the ownership of these companies. The WCO should update the database annually and require countries to report this information on an annual basis;

4. **GET MORE COUNTRIES TO COMMIT TO RKC SAD2:** At the top of the agenda for the deepened international cooperation (Recommendation #1) among the WCO, WTO, ITC, UNODC, UNCTAD, INTERPOL, and the OECD should be a coordinated international campaign to get many more countries to sign and ratify the Revised Kyoto Convention, especially Chapter 2 of the Specific Annex D (RKC SAD2), which makes clear that goods located in FTZs are regarded as being outside the customs territory solely with respect to import duties/taxes levied – but the zones themselves are still part of the territory of the country in which the zone is located, and over which the national customs authority has oversight;

5. **AMEND LEGISLATION AND CHANGE REGULATIONS THAT PROVIDE "EXTRATERRITORIALITY":** In the spirit of compliance with RKC SAD2, countries should amend any legislation or revise regulations that deny their national customs agencies full regulatory authority over both the goods and the activities inside their zones;

6. **ADOPT THE OECD RECOMMENDATIONS AND CODE OF CONDUCT FOR FTZs:** All countries – including those beyond the 32 OECD members – should adopt and fully implement the OECD's "Recommendations on Enhancing Transparency in Free Trade Zones" and adhere to the corresponding "Code of Conduct for Clean Free Trade Zones";

7. **IMPLEMENT THE WCO GUIDANCE ON FTZS AND REQUIRE AEO STATUS:** All countries should implement the WCO's "Practical Guidance on Free Zones," should participate in the WCO's SAFE Framework, and should require all companies operating within their FTZs to meet the WCO's Authorized Economic Operator (AEO) status;

8. **USE THE NEW RISK-ASSESSMENT TOOL BY RUSI:** Private-sector services engaged in trade, trade financing, and related activities in FTZs, such as banks, insurance companies, shipping lines, and freight forwarders, etc., should use the freely available online risk assessment tool developed by RUSI to better understand their exposure to the risk of facilitating illicit financial flows as a result of operating in an FTZ. The tool assesses FTZs by distinguishing between compliant (clean) and non-compliant (risky) FTZs.

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