



PHILIP MORRIS
INTERNATIONAL

Fighting Illicit Tobacco Trade in Free Zones

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Executive Summary

To succeed in our mission to create a smoke-free future, it is imperative to eradicate illicit trade wherever it exists.

Philip Morris International (PMI) is committed to fighting illicit trade and has implemented a wide range of policies and processes to do so. Tackling illicit trade requires collaboration and public-private partnerships, and we stand ready to continue working with public and private actors alike to make full use of existing expertise, information sharing, innovative solutions and evolving technologies. Securing our supply chain and fighting illicit trade is an integral part of our efforts to drive operational excellence and achieve a smoke-free future. As part of those continued efforts, we would like to see effective regulation of Free Zones (FZs).

Illicit trade is a serious and growing threat to society. Through smuggling, counterfeit and tax evasion, governments are losing billions in lost tax revenues, legitimate businesses are being undermined, and consumers are being

exposed to poorly made and unregulated products. Today, tobacco is one of the most common illegally traded goods in the world, with as much as 10 percent of global cigarette consumption sourced from the black market, according to the World Health Organization (WHO).¹

Philip Morris International (PMI) is leading a transformation in the tobacco industry to create a smoke-free future, and ultimately replace cigarettes with smoke-free products to the benefit of adults who would otherwise continue to smoke, society, the company and its shareholders. Illicit trade makes cheap, unregulated tobacco products easily accessible, undermining efforts to reduce smoking prevalence and protect youth from smoking. To succeed in our mission to unsmoke the world, it is imperative to eradicate illicit trade wherever it exists.

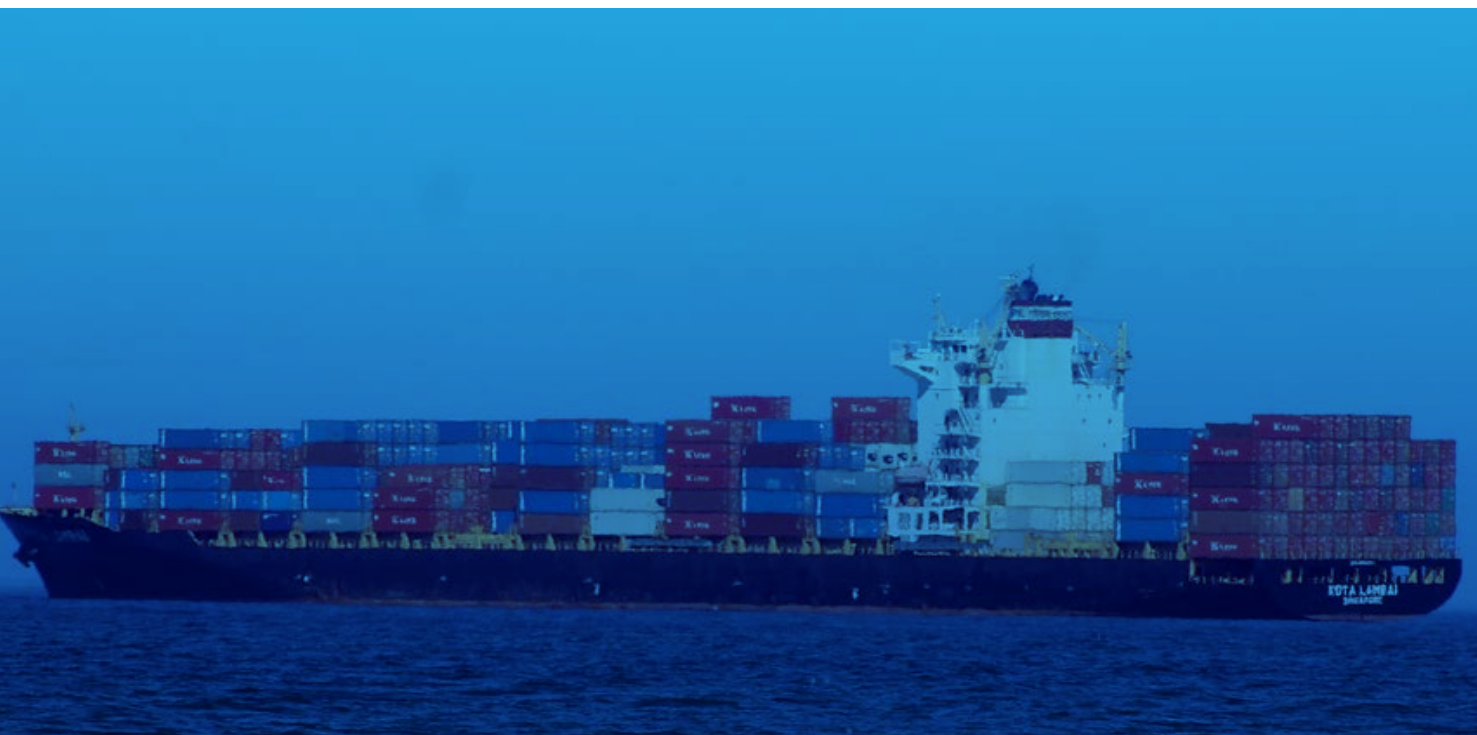
¹ WHO: <https://www.who.int/news-room/fact-sheets/detail/tobacco>

FZs are areas of economic activity within a country's jurisdiction where goods that enter the area are exempted or subject to lower import or export duties than those applicable if goods were released for free circulation at the moment of their entry. By their nature, FZs facilitate trade and remove administrative burden, and have played an important role in economic growth and in advancing global trade. However, local laws provide little guidance on how FZs should operate and evidence shows that reduced controls in FZs have made them highly vulnerable to illicit trade (production and transit), money laundering and other criminal activities.

PMI supports effective controls and regulation of manufacturing, trade and international transit of tobacco products within FZs. Such regulation needs to be implemented and enforced effectively without disrupting the legal trade and legitimate businesses.

We have long been supporting the objectives of the Protocol to Eliminate Illicit Trade in Tobacco Products² (the Protocol) to the WHO Framework Convention on Tobacco Control (FCTC), and we have welcomed its entry into force. Article 12 of the Protocol refers to FZs³ and requires that Parties implement controls on manufacturing and transactions of tobacco and tobacco products in FZs, and on the international transit or transshipment of tobacco products and tobacco manufacturing equipment. We agree with the principles of Article 12, and we recommend a comprehensive approach to implement effective controls on manufacturing and transactions involving tobacco in FZs.

In this paper we seek to explain the issues related to FZs and propose possible solutions.



² The Protocol to Eliminate Illicit Trade in Tobacco Products, https://www.who.int/fctc/protocol/illicit_trade/protocol-publication/en/

³ It bears noting that Article 12 talks about regulating two different, albeit related, matters: FZs and international transit. In this paper, we focus on FZs and any discussion of international transit is in relation to FZs.

Free Zones: Introduction

The Revised Kyoto Convention⁴ (RKC) defines FZs 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”.⁵ Their primary purpose is attracting foreign investment and encouraging economic growth. This is primarily achieved through simplifying customs procedures.

⁴ Revised Kyoto Convention – See also the Appendix in this document ⁶ <https://www.fdiintelligence.com/Locations/Free-Zone-Focus-free-zones-and-the-OECD-join-forces>

⁵ Revised Kyoto Convention, Specific Annex D, Chapter 2. - See also the Appendix in this document

It is easy to see why FZs have become so popular. They have championed the exchange of goods and services in an agile way, with little or no direct taxation and much less bureaucracy. To put FZs in perspective, almost 40 percent of all international trade is reportedly run through FZs (in some countries as much as 70 percent of exports rely on FZs), generating more than 80 million direct jobs.⁶

Despite their positive contribution to international trade and economic growth, there is, however, a darker side to FZs. Relaxed regulations, reduced oversight and softened customs controls have made FZs increasingly vulnerable to a wide range of abuses by criminal actors, including illicit trade and money laundering. As far as illicit trade in tobacco, FZs can be both a source and a transit point.

Manufacturing in FZs has limited or no customs oversight and is generally not subject to the same controls as those applied to domestic manufacturing of excisable goods. The volume of source materials, such as paper, acetate tow, filters, raw tobacco, and finished cigarettes imported into FZs are generally not tightly controlled or recorded, making it very difficult to match production input and output and to reconcile inputs with production. This makes it easier to under-declare production volumes.

Products that enter and exit FZs pass through various economic operations (e.g. processing or repackaging) with almost no control or oversight. Therefore, if illicit activities do take place along the product's journey

through FZs, law enforcement would be blind to it. Furthermore, the absence of a requirement to conduct due diligence on business partners diminishes the accountability mechanisms for operators within FZs and the efficiency of any potential control measures.

Movement of goods within the FZs and exports from the FZs are not subject to strict customs controls, making it difficult to know whether the goods have actually left the FZs. Illicit cigarettes are often hidden in containers with other cover loads that would attract a lower import duty at their destination. With limited Customs' oversight, trans-shipment of consignments through FZs can also contribute to making it difficult to trace consignments back to their point of origin.

Criminal organizations take advantage of few inspections of large shipments, limited supervision on importation, re-labeling, export and repackaging in FZs. The fact that taxes or duties are generally suspended for the merchandise produced or stored in FZs does not mean in any way that FZs are outside the laws that guarantee international best practices. FZs need better regulation and enhanced transparency to prevent illicit trade, taking into consideration the already existing international agreements developed by international organizations in an attempt to structure much needed regulations (for more information on these, please see Annex 1).

FZs need better regulation and enhanced transparency to prevent illicit trade.



⁶ <https://www.fdiintelligence.com/Locations/Free-Zone-Focus-free-zones-and-the-OECD-join-forces>

What we think about Free Zones (FZs)

The Protocol is an international treaty and the first protocol to the WHO FCTC. It builds upon and complements Article 15 of the FCTC, which recognizes that the elimination of all forms of illicit trade in tobacco products is an essential component of tobacco control. PMI has long supported the measures proposed by the Protocol and has welcomed its entry into force. With international scope and a broad remit to address the multiple drivers of illicit trade, we believe that the Protocol is a milestone in the fight against illicit tobacco trade. Article 12 of the Protocol refers to “Free zones and international transit” and requires that Parties implement controls on manufacturing and transactions of tobacco products in FZs, and on the international transit or transshipment of tobacco. We agree with the principles contained in Article 12, and we recommend a comprehensive approach to regulate manufacturing and transactions involving tobacco in FZs. Such regulation needs to be implemented and enforced effectively without disrupting the legal trade and legitimate businesses.

We recommend a comprehensive approach to regulate manufacturing and transactions involving tobacco in FZs. We believe that a comprehensive approach should include the following measures:

Customs *ex officio* oversight over FZs

As an overarching principle, relevant national authorities – notably Customs – should have full access and oversight in FZs and apply controls, enforcement and sanctions to FZs as in the rest of the national territory.

As part of the geographic territory of a country, FZs are also part of the country's Customs regime but with special prerogatives and tax benefits. The common misperception that FZs are not under Customs' authority leads to lax customs supervision and lack of transparency.

National legislations should be amended, where necessary, or applied in practice to empower Customs with authority over goods in FZs. This is in line with the Revised Kyoto Convention, which provides that Customs shall have *ex officio* the right to carry out at any time checks on the goods stored in a free zone.

Licensing

A licensing regime would allow authorities to have a complete register of those operators within FZs dealing with tobacco products, thus facilitating the identification of those who may be involved in illicit activity.

Countries should establish or designate a competent authority to issue licenses to manufacture, import, export, broker, or ship tobacco products, raw materials for the production of tobacco products, and any other key input necessary for the production of tobacco products. Customs authorities should be involved in the licensing and approval of entities operating in FZs.

For licensing regimes to be effective, they must be proportionate and practical, without creating

unnecessary additional burden or cost to the legitimate actors involved in the manufacture, import or export of tobacco products and manufacturing equipment. Licensing regimes should include monitoring systems, with provisions for revoking licenses of those failing to comply with specified requirements. The authority that issues the licenses should also be responsible for renewal, suspension, and cancellation of the licenses, in accordance with local law.





Due Diligence

Countries should require FZ operators to conduct thorough due diligence on any entity intending to operate in the tobacco supply chain within their FZ. Accurate inventory controls on tobacco products manufactured in or transiting through FZs are also needed.

As a responsible corporate citizen, PMI is thorough in the due diligence we conduct as part of every partnership, acquisition, or agreement. Our comprehensive Know Your Customer (KYC) guidelines help us meet our goal of only doing business with clients that share our high standards of integrity and ethical business practices.

If the due diligence we conduct results in negative findings, we choose not to do business with companies that are not fully compliant.

Licensed operators in FZs should apply due diligence and KYC practices to their clients, and adhere to the same compliance practices as those operating outside of FZs. FZ operators should conduct due diligence on any entity intending to operate in the tobacco supply chain within their FZ and subject license holders to local authorities audit requirements. High compliance standards create a level playing field among FZ operators, and eliminate corrupt practices.

Payments

Know Your Transaction practices should complement KYC to detect potential money laundering, often associated with illicit trade.

Payments should be allowed only in the currency and in the same amount as the invoice, and only through legal methods of payment from a financial institution.

To this effect, cash payments for any commercial or financial transaction by economic operators active in the FZ should not be allowed.

Reporting and record keeping

As part of a continuous due diligence compliance process, license holders should supply FZ operators and local authorities with regular reports on the quantity of tobacco and tobacco products they keep in custody and in warehouses under duty suspension.

As part of a continuous due diligence compliance process, license holders should supply FZ operators and local authorities with regular reports on the quantity of tobacco and tobacco products they keep in custody and in warehouses under duty suspension. Accurate record keeping should include the quantity of tobacco products and manufacturing equipment

in their possession; and the quantity of products they keep in custody or in stock, including in warehouses under duty suspension. This would allow matching production inputs and output, to reconcile inputs with production. Accurate inventory controls on tobacco products manufactured in, as well as entering and leaving FZs, should also be established.

Labeling

All tobacco products manufactured, repackaged or transported in FZs should comply with labeling requirements imposed by authorities in the countries of their retail sale.

FZs are not only places of tobacco manufacture, they are also significant transit points for both legitimate and illicit products. Since all countries specify their

labeling requirements for tobacco products, one of the easiest ways to identify non-compliant products is through their labeling.

Tracking and tracing (T&T)

Article 8 of the Protocol, which calls for the establishment of a global T&T regime, should be equally applicable within FZs as part of the territorial jurisdiction of a country.

Specific measures to secure international transit

In addition to FZs, intermediaries in the global supply chain, such as transport operators, are being used, knowingly or unknowingly, by criminal networks to enable illicit trade.

Processes and documentation used for international transit are crucial to help identify and stop illicit goods. To prevent diversion, license holders exporting tobacco products from FZs should provide the FZ operators with the following information before the products are shipped:

- a) Destination country
- b) Identity of the transporter, freight forwarder, or broker
- c) Intermediate ports, if any
- d) Details on products shipped, including: brand, variant, quantity, intended country of retail sale

International cooperation and exchange of information

Enhanced international cooperation in the exchange of law enforcement information, consultation, and collaboration with appropriate authorities and affected industries, are paramount to identifying risky consignments and conducting effective investigations.

Conclusion

FZs facilitate economic growth and are fundamental to an integrated global economy. Nevertheless, evidence shows that the existing regulations governing FZs have not been able to keep up with these advancements. This has unfortunately transformed many FZs into areas highly vulnerable to illicit trade and money-laundering schemes, as well as other criminal conducts.

Therefore, we strongly believe that all entities operating within FZs should adopt best practices on the supply chain controls, including licensing, labeling, due-diligence and T&T for goods. National authorities – notably Customs – should *ex officio* monitor and exercise oversight in FZs.

Cooperation between the authorities at the national and international level, as well as collaboration with the private sector, must be prioritized to comprehensively tackle illicit trade. Information exchange is key in identifying illegal activities and we are determined to work with authorities to eradicate illicit tobacco trade. A universal set of best practices for FZs operators is much needed. The objective should be to achieve a level playing field, where all legitimate participants in the tobacco supply chain are empowered and expected to operate in line with high compliance standards. Countries must focus on enforcing laws within FZs, a task which is long overdue.

At PMI we are committed to fighting the illicit trade and we have implemented a wide range of policies, best practices and processes to accomplish so.

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



APPENDIX
*Examples of Existing
International Treaties,
Recommendations
and Guidelines*



Revised Kyoto Convention⁷

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

The Convention provides that national legislation should specify the requirements relating to FZs, including the kinds of goods that can circulate and the nature of operations that should be allowed to take place. The Convention also provides that local customs authorities should set the arrangements for customs controls including the suitability, construction, and layout of the FZ.⁸

The question of responsibilities within FZs is raised within Specific Annex D, where Chapter 2 refers to the role of Customs in FZs, and describes the guidelines in relation to the establishment, management and control of FZs, the admission of goods, authorized operations, the duration of the stay, the assignments and the withdrawal and evaluation of the goods.

Within this chapter there are two relevant points that are worth highlighting:

- Standard 4, which states that The Customs shall have the right to carry out checks at any time on the goods stored in a Free Zone
- Recommended Practice 6, on the admission of goods, which reinforces the importance of the protection of intellectual property rights and prohibiting access to counterfeit goods in FZs.

⁷ http://www.wcoomd.org/en/Topics/Facilitation/Instrument%20and%20Tools/Conventions/pf_revised_kyoto_conv/Kyoto_New

⁸ OECD, ITIC Toolkit to Reduce the use of Free Trade Zones for Illicit Trade in Tobacco Products, March 2017. p.2

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

- The TRIPS agreement is a multi-lateral framework developed to prevent the international trade in counterfeit goods that came into effect in January 1995 and was adopted by member states of the World Trade Organization. TRIPS requires member states to adopt measures which permit the suspension of customs procedures for counterfeit and pirated goods, and suggests specific procedures for the suspension of customs clearance for goods suspected of being counterfeit, as well as a prohibition on re-export of counterfeit goods.
- The TRIPS agreement also requires member states to impose criminal penalties for willful commercial-scale of counterfeit goods, and counterfeiting and piracy, to the same degree it penalizes other criminal acts.⁹ The TRIPS Agreement makes no special provisions for FZs. Due to the special customs treatment of FZs, some countries have misinterpreted the Free Zones' customs regime as outside the customs jurisdiction for non-tariff matters.

Recommendation on Countering Illicit Trade: Enhancing Transparency on Free Trade Zones (OECD)

On October 21, 2019 the OECD Council adopted the "Recommendation on Countering Illicit Trade: Enhancing Transparency on Free Trade Zones (FTZ)"¹⁰, which aims to assist governments and policy makers in reducing and deterring illicit trade conducted through and inside FZs. The Recommendation includes a "Code of Conduct for Clean Free Trade Zones" (CoC) as an annex. This CoC has several provisions, such as:

- "Provide unconditional access to the competent authorities, in accordance with their domestic law, to carry out unobstructed, *ex officio* enforcement checks of operators in support of investigations of violations of applicable laws and regulations".
- "Prohibit operators and persons who do not provide the necessary assurance of compliance with the applicable customs provisions from carrying out an activity in the FTZ".
- "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".

FZs should be encouraged to comply with the CoC. Internationally accredited and independent verification firms should certify the FZs' compliance with the CoC.

To find out more



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