Methodological Guidance on Money Laundering vulnerabilities of Free Trade Zones

Conception

Free Trade Zones (hereinafter FTZs) are created within different countries or territories to stimulate trade, develop business and attract foreign direct investments. These areas offer a favorable environmentfor export-related services and goods, as well as companies permitted to work in these zones are subject to minimum regulation.The exemption from duties and taxes, simplified administrative procedures including import of raw materials, engineering equipment, spare parts andequipment exempted from custom duties can be considered as the additional benefitsof ATZs. These areas are defined as “free zones” in the InternationalConventionon theSimplificationandHarmonization ofCustomsProcedures(The Kyoto Convention). At the same time, the activity of FTZsis not limitedonly tobusiness activities as it is possible to meet there retailsalesenterprises, settlements, financial services and even tourism andcasinosectors.

Thus, an FTZ is an area or regime within a country’s territory with a special status concerning customs and/or tax controls, in which enterprises conduct their business or provide services for export/import purposes through the granting of special privileges to stimulate their development.

Stages of developmentand typesofFTZs

Despite a nearly 300-year history of an FTZ, the first modern zone is the Shannon Free Zone established in Ireland in 1959.Having contributed to the development of local economy, later this zone served as a model for the zones established around the world under various names and aimed at the development of trade and economy.

1.*Free TradeZones*–generalpurpose duty-free areas offering warehousing and distribution services for trade, transportation and export purposes.These zones are mostoften located in ports. Examples: ColonFreeZone(Panama), Singapore.

2. *Export Processing Zones* –industrail areas established by numerous countries to increase industrial and commercial exports. These industrial zones most often bring together labor-intensive, light industrialbusinesses(foe example: as garment production and the assembly of electronics.) According to the 2003 statistics, the export processing zones operating in 116 countries around the world employed 43 million people. Example: Karachi (Pakistan).

3. *Enterprise zones* – economic development areas established to develop special urban and rural areas where they are located through tax incentives and financial grants. This type of zones is most often found in the developed countries. Example: Docklands, London (Great Britain and Northern Ireland)

4. *Free ports* – are believed to be the largest of the zonesaccommodating such activities as tourism, retail sales, etc. Free portsproviding numerous incentives and benefits differ from the traditional free trade zones as they arenotan export driving mechanism but areas contributing to overall economic growth by linking these zones to a country's economy. Example: Hong Kong, China

5. *Single FactoryExport Processing Zones*– Some researchers do not attribute this type of zones to the free trade zones. These zones consist of a single factory that is located anywhere in a country and provided with special duty free privileges similar to other zones. These zones can be found in Mauritius andMadagascar.

6. *Foreign Trade Zones*–The term is commonly used in the United States. They are established in or adjacent to ports where all types of merchandise may be kept without applying the U.S. customs duties.

7. *Special Economic Zonez*– This type of zones extends tax and adminitration incentives of the free trade zones tosuch areas as investments, labor laws, management and wage rates. Despite being originally applied only in China, now these zones exist in India and other countries.

8. *Special Warehouses*–Specially designated warehouses which are under control of Customs authorities.

In addition to the zones above, there are a number of other zones. These zones usually specialize in a particular area. Examples: Dubai Internet City (UAE), Labuan Offshore Financial Centre (Malaysia).

Vulnerabilities of Free Trade Zones

Free areas and zones vary from area to area, from country to country. Free zones may differ from each other in operations, control and requirements even within one jurisdiction. There is no standard approach within each zone, and it is derived from a global snapshot of this area. FTZs apply special laws and regulatory mechanisms in accordance with the type of activity and economic development of these areas for being a separate customs zone to encourage trade and direct investments. These features provide opportunities to create conditions for business development as well as enable criminals to misuse weaknesses of the system. Loopholes in the system are favorable conditions for abusing it by money launderers and terrorist financers. Although FTZs differ from each other in their nature, often they present similarities with regard to their vulnerabilities.

Application of AML/CFT measures in Free Trade Zones

Application of AML/CFT requirements towards FTZs is a new trend. While AML/CFT requirements are widely applied in the financial sector, they do not often extend to business and investment sector. FTZs are developing more rapidly than the rules and procedures applied in these territories, somany of the current rules and procedures governing FTZs are outdated. In previous years,the adoptedrules and procedures did not take into accountAML/CFTrequirements. Althoughthe development of the business environment in FTZs was supported,this created an opportunity for criminals to take advantages ofthis system. Many countries do not apply the same AML/CFT requirements in an FTS as they do in other jurisdictions. In particular,the requirements relating to the AML/CFTpreventivemeasures – a commitment to reportlarge-value currencytransactions andsuspicious transactions– are not applied to FTZs as business entities operating in an FTZ remain beyond the traditional financial sector. The use of cash in FTZs facilitates trade transactions. Cash does not require financial institutions, and its anonymity and lack of an audit mechanism lead to higherML/FT risks.

Weak oversight and lack of transparency

The scopeand degreeof customs control overthe goodsin FTZs, ATZateconomictransactionsvary depending onthe jurisdiction. In accordance with purposes of establishing FTZs, goods in a FTZ are generally not subject to the customs controls. Therefore, there is a risk of misusing FTZs for commercial frauds.Goods delivered to FTZs can undergo various economic operations (transshipment, sorting, manufacturing, processing, warehousing, re-packaging, re-labelling, storage for timely trading, delivery). The tracking of shipments and re-packaging is key operations in the control system over FTZs. Variousshipping operations under the same name may be a base around the globe for laundering money.Although the conditions for FTZs are often dependent on the level of the customs control or relevant management authorities, and the kinds of operationsare subject to the approval of these authorities, the degree of customs intervention is sometimes insufficient and sometimes even absent. The lack of control over this type of operations can lead to cutting off the monitoring of the international shipping and breaking the “chain”. Licensing procedures and control measures in FTZs are often complicated and bureaucratic which can hinder exercising controls. Loopholes in regulations weaken control measures. In some cases the jurisdiction of the government or the customs authorities to exercise controls is not fully reflected. The survey conducted in this type of the areas indicates that the controls are carried out by random selection more thanin accordance withspecific risk assessment procedures and that no documentation relating to organization and execution of the examinations is identified.

Possible actions to prevent and detect commercial fraud cases in FTZs can be carried out in two different ways: I) to determine the level of customs control over accepted goods and the business operations and ii) to assess the level of risk associated with goods arriving from FTZs. The local authorities operating in FTZs independently of the national government aim at attracting businesses through simplifying registration of a legal entity and other similar issues. Most of FTZs are less interested in getting information about a beneficial owner during the registration of legal entities in these areas. As a result, legal entities may conceal information about their beneficial owners when setting up in FTZs. In addition, it is possible to bypass AML/CFT requirements applied in FTZs during the process of incorporating a legal entity. This is considered to be a tool to access the financial system in the same or any other offshore zones.Analysis of the survey conducted in an FTZand jurisdictions for business organization in FTZs showweak points in identifying and checking a beneficiary assigned for legal entities. Besides, the survey also verifies that physical presence of legal entities in FTZs is not always a requirement.

Lack of Systems Coordination

Customs document management and administration varydepending on regions, countries and customs area.Despite the lackof systematic integration in mostcases, theoretically transactions being performed in an FTZ must be reported to administrative and customs authorities. In addition, there is a poorly set up system coordinating efforts of customs authorities,local authorities,federal or stateoversightbodies andlaw enforcement agenciesin FTZs.

Typologies of ML/FTtransactions carried out in FTZs

Typology 1:

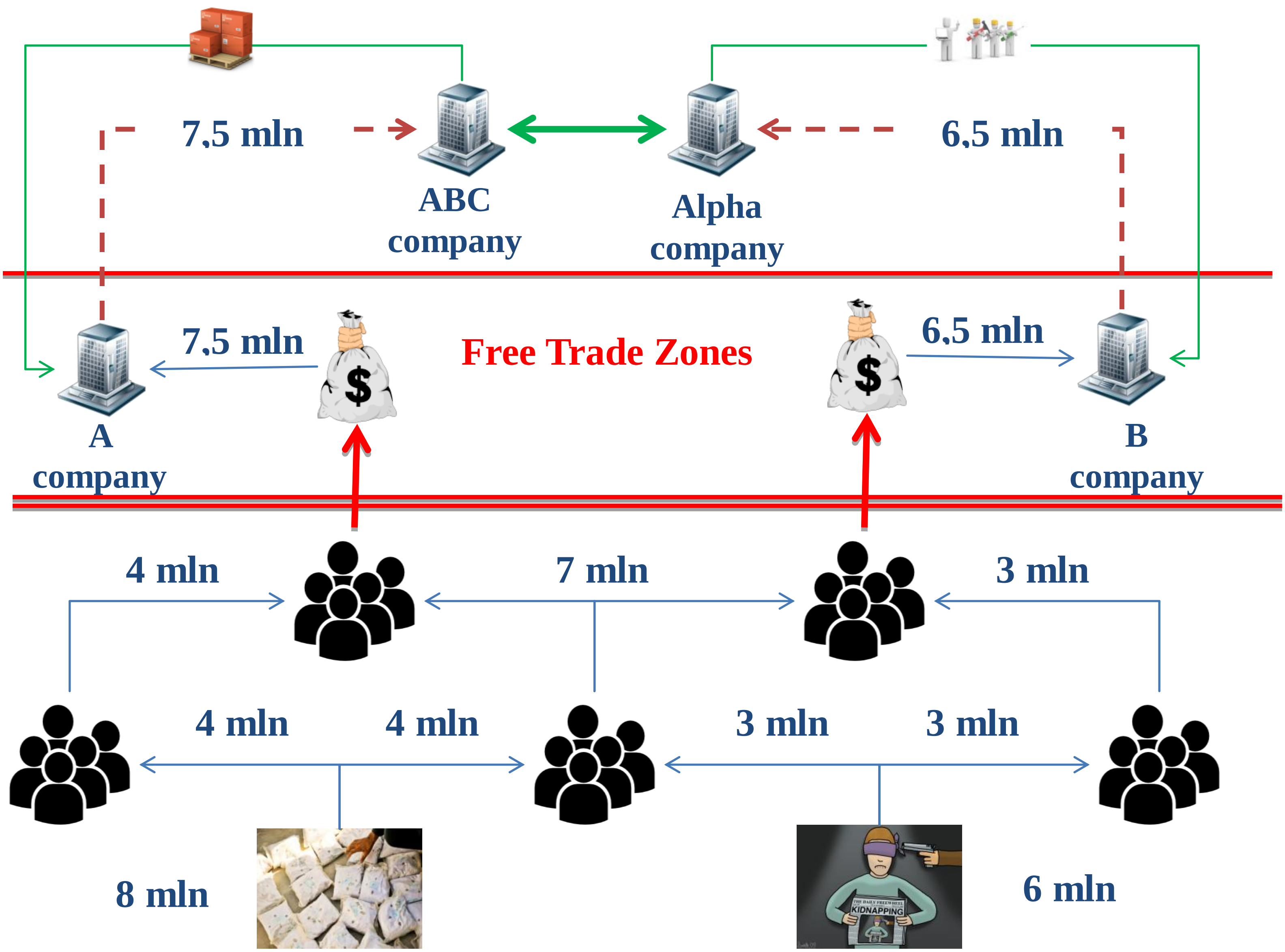
<u>Bringing cash to Free Trade Zones</u>

Total 14 mln AZN obtained through drug trafficking and child abduction were collected by 3 groups in 3 countries during 4months. Collected fundswere concentrated in2 groups through cashandother money transfer operations. These two groups transfer funds in cash to Free TradeZones. Due to the lack ofanyoversight mechanism here, thecash is deposited into bank accounts of 2 fictitious legal entities (A and B companies).

Noany financialtransaction is carried out within 6 months afterthe lasttransactions. However,6months later, money (funds deposited into the bank account 6 monthsbefore) are transferred from the accounts of A and B companies into the accounts of the ABCandAlpha companies incorporatedin X countryin parts 3 times in 4 months.Money transferred to the account ofABCCompanyis designated "for thepurchase ofgoods and materials" while money transferred into theAlphaCompany's account – for "providing services."

The investigation reveals that founders of both companies(ABC and Alpha companies) arethe same persons.

Control over the work has started at the time of the first transfer from a Free Trade Zone to 2 legal entities incorporated in X country. Theinvestigation periodwas1year and 2 months.



Typology 2:

<u>Black Market currency exchange (a preferable alternative to banks)</u>

Step 1:

The Free Zone-based company is a wholesaler that buying goods from an Asian manufacturer. The goods are shipped to Curacao by ship. The goods stored in warehouses of Free Zones are exempt from tax. The payment is made in U.S. dollars.

Step 2:

70% of goods are sold in retail stores in Venezuela. Due to strict currency restrictions in Venezuela, retailers found it difficult to buy U.S. dollars. For this reason, related companies are forced to look for alternative payment methods.

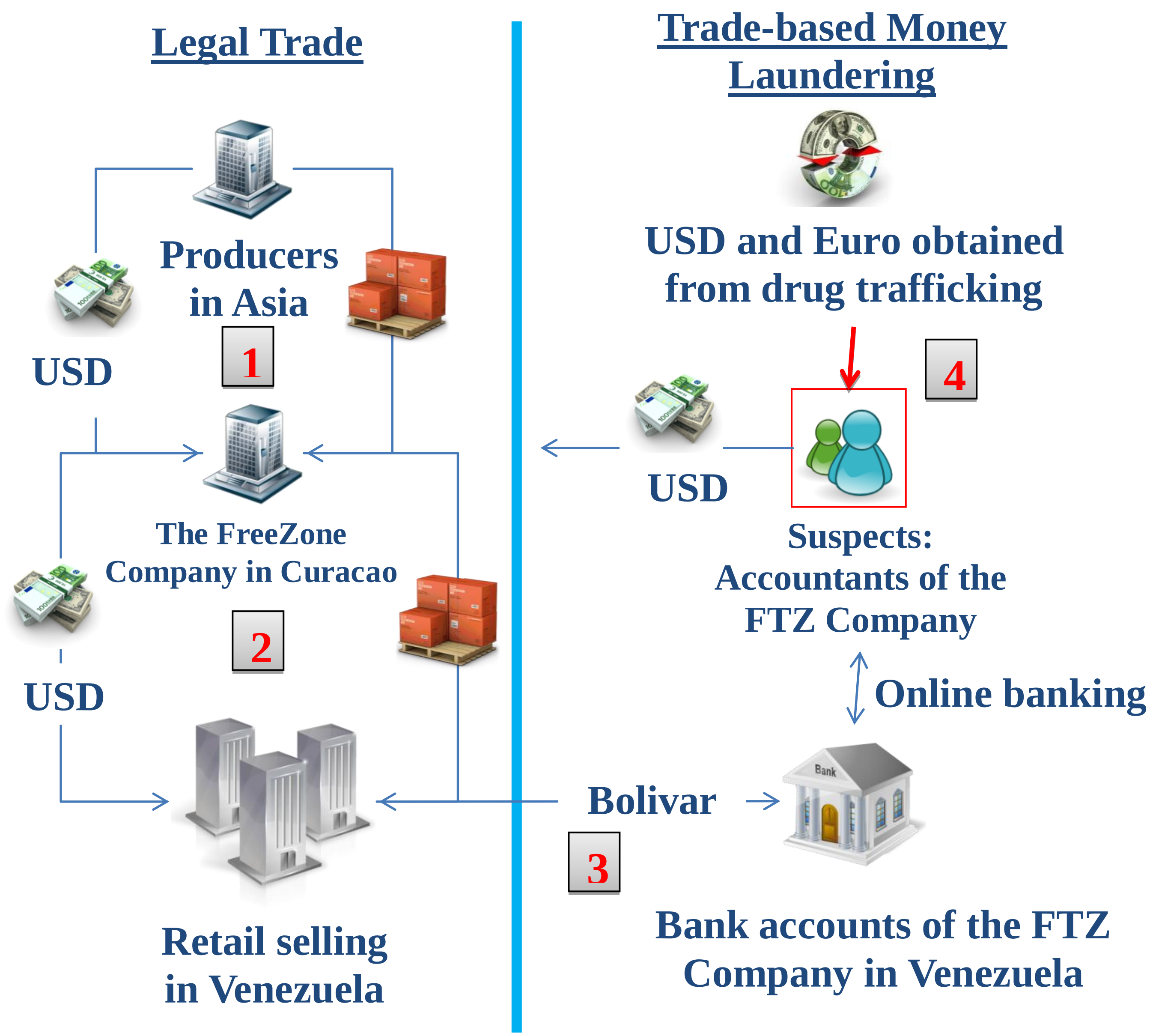
Step 3:

The Free Zone Companyreceives payment for a wholesale transaction in bolivares (Venezuela's national currency)to an account at a bank in Caracas. For this purpose the Free Zone wholesaler opens3 accounts at a bank in Caracas in the names of three employees holding a position ofaccountant. The employees in question have easily obtained Venezuelan citizenshipfor this purpose. The accounts are managed online from Curacao.

Step 4:

Millions of U.S. dollars and euros, in cash, were deposited into the Free Zone Company's bank accounts in Curacao. The company claimed the money obtained from the sale of the goods in Venezuela. The Free Zone Company'saccountants also engaged in foreign exchange dealings by selling some of the cash to other companies.The accountants earn money through commission fees charged for currency exchange. The Free Zone Company exchangesbolivares for dollars, and thus the drug-related proceedsare laundered through this way.

The case resulted in 11 arrests, the confiscation of 3500000 Netherland Antilles guilders (the currency for the Netherlands Antilles) and 1 billion Venezuelan bolivares (approximately USD 500,000) as well as real estate and luxury cars.



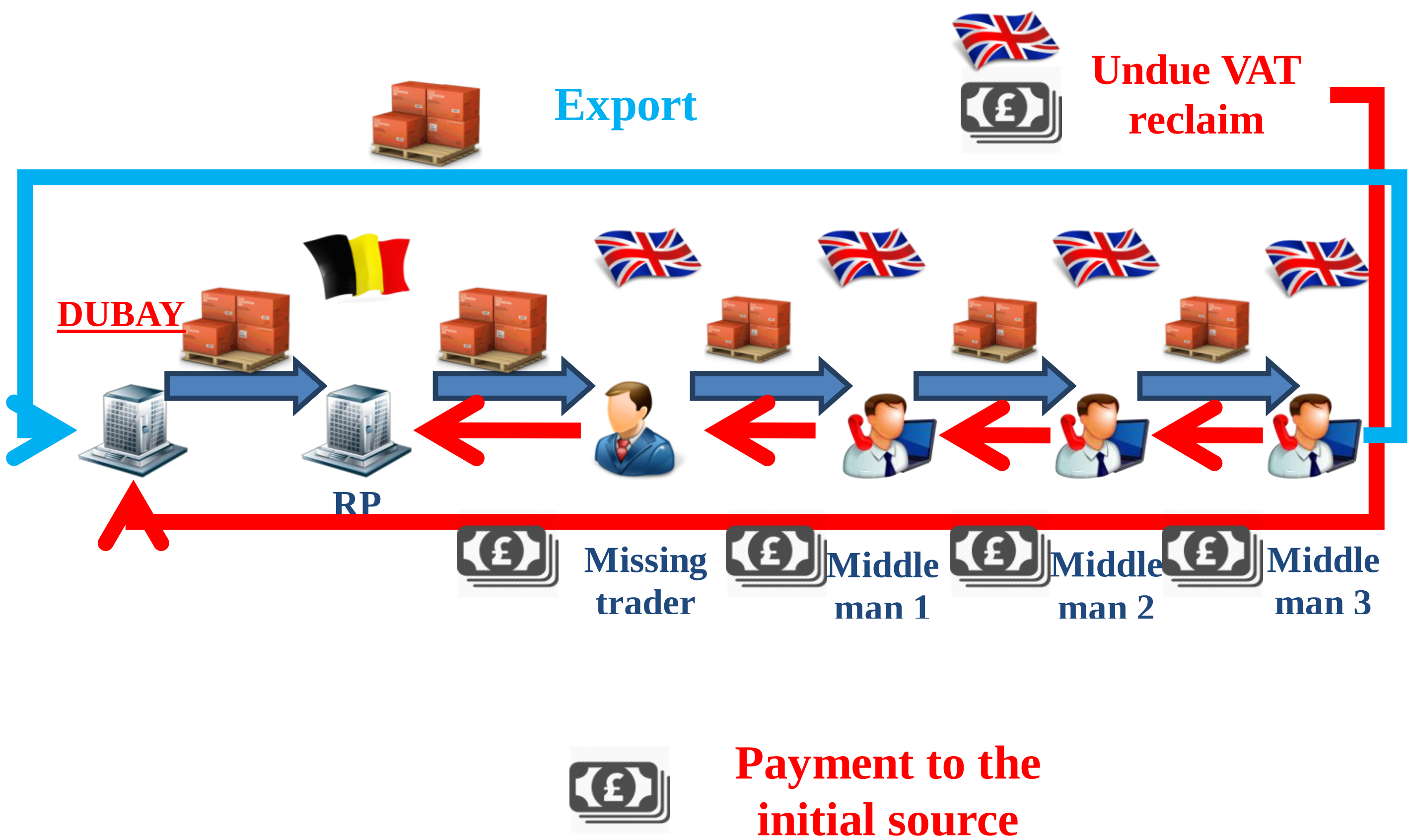
Typology 3:

Carousel Fraud: "Dubai Connection"/Misuse of State Budget/Trade Based Money Laundering

The Belgian company is associated with international Value Added Tax (VAT) circular (carrousel) crime. The company is involved in import-export operations related to the sale of goods in Dubai and prepares documents for British customers. A "missing trader"[1] plays a key role in coordination. The invoice scheme in the United Kingdom involves various middlemen who buy goods from missing traders and then

[1]A missing trader/businessman – a party involved in VAT evasionto the detriment of the state budget. Usually this type of tax evasion goes around in a circle. Therefore, it is called "the carousel fraud."

re-export them to Dubai. Thus, they reclaim the VAT from the UK Treasury. A payment order is signed at every stage of the invoicing scheme and in exchange related persons obtain "income." The circular invoicing scheme assumes that the last payment for goods is made in the United Kingdom to the initial supplier in Dubai.This last amount includes the British VAT. The amount of evaded tax is transferred to a bank account in Dubai.



The payment to the company in Dubai is not made until the fraud cycle is complete in Europe. This scheme exposes the lack of an oversight mechanism associated with activity of legal entities established in FTZs.

Typology 4:

Trade Based Money Laundering/Black Market Currency Exchange (a preferable alternative to banks)/Terrorist Financing

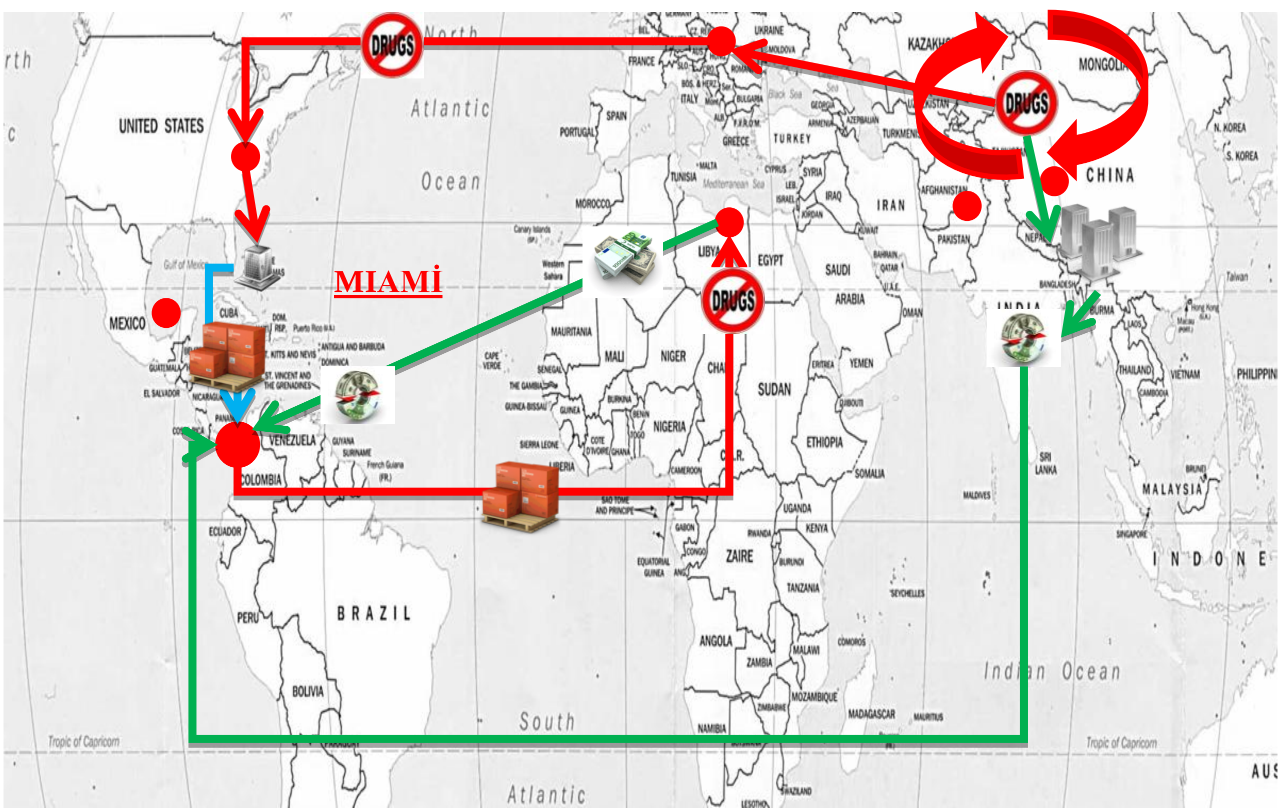
This work involves criminal groups operating in Colombia, Central and South America, Europe, Asia, the Middle East, Mexico and the United States. The investigation revealedroutes of transporting tons of cocaine to various locations worldwide, a Colombian/Lebanese drug trafficking and extensive money laundering network linked to the Islamic extremist organization Hezbollah in Lebanon. To ensure that the smugglers could operate in the Middle East, a portion of drug proceeds sold in this region was directed to

Hezbollah leaders operating in Libya. The network also had a central money laundering station in Asian trade-based country I's. The network was sending 15 million USD monthly to Colombia via the Black Market Peso Exchange (BMPE) after exchanging drug proceeds in Asian-based financial institutions and trading companies. The proceeds from drug trafficking were transferred to Country I based bank accounts controlled by the Colombian businessmen who were purchasing currency from peso brokers and shipping commodities to South America.Smugglers were receiving money before or after the sale of goods.The network was able to senddrug proceeds through country I back to Colombia, which is the drug trafficking source. A number of businesses in the Colon Free Trade Zone (CFTZ) in Panama participated in this scheme as a point of delivery of drug proceeds in bulk cash.

There is also a BMPE scheme based in Miami. An electronics company in Miami was obtaining drug proceeds from US bank accounts in exchange of goods shipped to Colombia.

Transactions between companies and the relevant documentation for import and export operations in the Panamanian CFTZ are kept in the CFTZ administration and PanamanianCustoms system.

The network controlled by the same center in different continents was operating through taking advantages of FTZ's vulnerabilities and loopholes in the legislation.



ML/FTrisk indicators

The red flag indicators for illegal activity in free tradezones have been collected through the survey and practical exercises. Monitoring entities should give priority in their activityto the listed indicators and specify the grounds forsuspicion.

Red flag indicators associated with financial institutions:

- The method of payment requested by the client is inconsistent with risk factors of a transaction.
- The transaction requires to pay third party that have no apparent connection with the transaction in cash or using other payment method.
- The transaction involves the use of frequently changing payment orders.
- A legal entity with low capitalisationthat carries out many large-value daily transactions which are disproportionate to its capitalization.
- A legal entity regularly deposits large sums into an account andimmediately expends them.
- Use of fiduciary companies established in FTZs.

Red flag indicators associated with unusual business activity:

- Goods aretransshipped through a number of countries without any reason.
- A circuitous route of shipment and/or circuitous route of financial transaction.
- The trading activity includes shipment of goods inconsistent with the geographical position.

Red flag indicators associated with Trade Based Money Laundering:

- Identification of significant discrepancies between the description of commodities and the actual goodsshipped.
- Significant discrepancies between the value of commodities reported on the invoice and the fair market value.
- The size of the shipment appears inconsistent with the scale of the exporter or importer's regular business activities
- The size of a shipment appears inconsistent with the exporter or importer's regular business activities.
- The type of a shipment appears inconsistent with the exporter or importer's regular business activities.
- Inconsistencies in information contained in trade and accounting documents, such as a list of commodities, names of companies, etc.
- A discrepancy between the volume of a shipment and a shipping cost.
- Containers with the same goodsare repeatedly exported and imported. It can be provided as an example of circulation of the same goods.
- Import of goods incompatible with the technical level of a country.
- Orders for goods are placed by legalentities or individuals from a country other than the country of the stated final consumer.
- An address of a shipping company is indicated as acommodity's final destination.
- Delivery of traded goods toaddresseslocated inlocalitiesadjacent to boundaries.
- Goods that can be easily bartered (cigars, tires, gasoline) sold to traders in the regions close to the boarders.
- Goods that are more prone to ML(artworks, precious stones, tobacco products, etc.) should be more closely monitored.

Risk indicators associated with shell companies (physically non-existent):

- The transaction involves the use of shell companies.
- Improperly invoiced export transactions involving tax havens.
- Qeyri-adi əməliyyatlar aparan və ofşor mərkəzdə yerləşən şirkətlərdən istifadə olunması (məsələn Dubayda mövcud olan şirkətə Belçikada yerli kommersiya fəaliyyətinin aparılması üçün kreditin verilməsi).
- Involving companies carrying out atypical transactions and located in an offshore centre (for example, loan to a Dubai-based company to carry out commercial domestic activities in Belgium).
- Involving third parties.

The law of Azerbaijan Republic No. 791-IIIQdated April 14, 2009 ‘OnSpecial Economic Zones’ is a regulatory basis for FTZs in our country. Despite the adoption of the law in question, there are no any FTZs in the territory of Azerbaijan. The lack of FTZsreduces the risk of committing ML/FT offences through FTZs. However, it does not rule out committing ML/FT crimes by conducting business operations in FTZs existing outside the borders of Azerbaijan Republic.Therefore, financial institutions should remain vigilant when conducting cross-borderbusiness operations andanalyze the formal requirements of thelisted risk indicators for transactions. The goal is to prevent proceeds criminally obtained in the territory of Azerbaijan from flowing as a legal property to an FTZ featuring poor control over business operations. This will also prevent inflow oflegalized money claimed to be legal from FTZsto financial institutions in Azerbaijan.