BRIEFING NOTE

FREEPORTS

FIRST PORT OF CALL FOR FINANCIAL CRIME?

APRIL 2021

INSIGHT | INTELLIGENCE | INNOVATION

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INTRODUCTION

In the March 2021 budget, the British Chancellor Rishi Sunak confirmed plans to bring eight new freeport sites into operation across the UK this year. This announcement has sparked contention amongst ministers and critics as to what the purpose and benefit of freeports are: do they boost employment and drive economic development or do they simply create another tax haven which can be exploited by criminals seeking to undertake and obscure fraudulent dealings?

Freeports operate as secure customs zones, usually near ports or airports, where business may be carried out inside a country's land border, although according to a different set of customs rules.[1] The UK's freeport model aims to allow companies to import and export goods tariff-free, only paying tax when the goods are sold in the domestic market. Freeports are nothing new – the UK operated seven between 1984 and 2012, when legislation establishing their use was not renewed – yet there is an increasing 'buzz' about the term (they have even featured heavily in Christopher Nolan's 2020 film Tenet) and the UK has seized the opportunity afforded by Brexit to establish freeports outside the constraints of EU regulation, aiming to drive employment, economic growth and innovation. However, financial crime experts and international bodies like the Financial Action Task Force (FATF) and the EU warn that the plan may open the UK up to serious financial crime vulnerabilities, and the European Parliament has gone so far as to call for the abolition of freeports across Europe.

There is some precedent for such pessimism. it is a well-established fact that so-called 'luxury freeports' have been used to facilitate a variety of illicit activities, allowing, for example, for art and other high value goods (HVGs) to be stored indefinitely or sold without the need to pay import tariffs, VAT or capital gains tax. The infamous drawn-out ownership dispute over the "Seated Man with a Cane" painting by Amedeo Modigliani, purportedly worth up to $30 million and looted by the Nazis during their occupation of France, is a case in point: it was seized in 2016 after being discovered in a luxury freeport following the publication of the Panama Papers, which identified a billionaire art dealer as the sole proprietor of the offshore holding company under which the painting was registered. [2]

In this briefing note, we consider the main financial crime risks associated with freeports - including tax evasion, trade in counterfeit goods, trade-based money laundering and terrorist financing - how these might apply in the UK in particular, and how regulators and the private sector can work together to mitigate such threats.

1. https://www.bdo.co.uk/en-gb/insights/freeports
2. https://www.icij.org/investigations/panama-papers/swiss-art-freeport-search/

WHAT ARE THE POTENTIAL LINKS BETWEEN FREEPORTS AND FINANCIAL CRIME?

The Modigliani case illustrates how freeports can be used for secure and secret storage, free from the need for customs declaration, creating not only an ideal environment for criminals to store illegally obtained goods but also one under which other illicit activities can flourish and thrive. Tax evasion, for example, is a common freeport-related crime, as additional information on the origin of goods or their ultimate beneficial owners is rarely required by the relevant national authorities. Furthermore, owners of high value goods placed in freeports are able to store these in a tax-free environment for indefinite periods of time during which their value and worth can potentially grow exponentially. This can promulgate more serious criminal activities, as exemplified through various cases in which terrorist groups, including the Islamic State, have repeatedly used luxury freeports to fund their terrorist activities through the illegal selling of stolen and looted art and antiquities from Syria and Iraq.[3,4]

The lack of beneficial ownership information requirements in a majority of freeports globally means that owners of goods placed in these zones are often able to remain anonymous. As a result, sanctioned companies and individuals (and those featured on other watchlists) are more likely to operate with ease, as anonymity renders thorough sanctions screening impossible. Freeports also provide an ideal ecosystem for parties engaging in the trade of counterfeit products. A 2018 report from the Organisation for Economic Co-operation and Development (OECD), for example, linked the establishment of a new free trade zone to a 5.9% increase in the value of counterfeit exports from the host country. [5]

Indeed, the FATF highlights that freeports are especially vulnerable to trade based money laundering (TBML) – i.e. the disguisal of criminal proceeds and movement of value through trade transactions in an attempt to obfuscate their illicit origins. Typical TBML schemes include the under, over and multiple-invoicing of goods, phantom shipments and the deliberate misrepresentation of quality, and they have proven to be an effective set of money laundering techniques since they are particularly difficult to detect. Whilst a wide range of economic sectors are vulnerable to TBML, certain goods, such as those with wide pricing margins (like beauty products and jewellery), extended trade cycles (goods which have been shipped across multiple jurisdictions) and those which are particularly difficult for customs authorities to examine, are even more likely to be exploited for this purpose. Freeports tend to be subject to weaker inspections than other trading zones and further facilitate TBML and broader money laundering schemes through the permitted self-declaration of export value and the more generalised acceptance of cash payments.

3. https://inews.co.uk/news/treasures-worth-billions-hidden-free-ports-fund-isis-31175
4. https://www.theartnewspaper.com/news/new-evidence-cited-in-heir-s-modigliani-restitution-claim
5. http://www.oecd.org/gov/risk/oecd-draft-guidance-to-counter-illicit-trade-enhancing-transparency-in-free-trade-zones-annex-2018.pdf

The ability to disguise the origin of funds through TBML is one of the main methods used by terrorist organisations to finance terrorist acts or their organisation's structure. Contrary to typical money laundering schemes, funds to support terrorist activities and organisations can originate from legitimate sources, such as from donations and profits from legitimate businesses, as well as from criminal activities, such as the drug trade or weapon smuggling.

There are few better case studies to demonstrate the terrorist financing risks associated with certain freeports than that of Nader Mohamad Farhat, a businessman who operated in the Tri-Border Area (TBA) of Paraguay, Argentina and Brazil – an area renowned for the production, movement and sale of contraband and counterfeit goods. Farhat was extradited to Miami in 2019 on charges of co-conspiracy to launder millions of dollars for the terrorist organisation Hezbollah, using trade-based schemes to launder ill-gotten funds, largely derived from the sale of narcotics. [6,7,8]

With its sea access and freeports, the TBA offers an ideal environment for TBML and related criminal activities – and that's before even taking into consideration the region's inadequate anti-money laundering (AML) and combatting the financing of terrorism (CFT) safeguards, the weak coordination and cooperation between the Brazilian, Argentinian and Paraguayan governments, and the TBA's geographic location, which presents an easy gateway for drug trading from South America to the US and Europe.

6. https://1fortlauderdale.com/paraguayan-money-man-in-middle-of-miami-new-york-laundering-cases-faces-extradition/
7. https://foreignpolicy.com/2019/07/19/to-fight-terrorists-follow-the-money/
8. https://www.fdd.org/analysis/2019/06/21/suspected-hezbollah-financier-extradited-to-the-u-s/

ARE THESE FC RISKS RELEVANT TO THE UK'S NEW FREEPORT PLANS?

The UK has confirmed that it has no intentions to operate 'luxury freeports', over concerns around their use for HVGs storage, which goes some way towards negating the risk of tax evasion, money laundering and terrorist financing associated with many other freeports worldwide. Furthermore, despite Brexit, the UK has committed to following the EU's Fifth Anti Money Laundering Directive (5AMLD), which came into force in January 2020 and which aims to tackle the abuse of the financial system by bad agents funding criminal activities and terrorism, and obfuscating ill-gotten funds. With 5AMLD, public authorities and private sector actors alike have been obliged to take extra measures to identify and report suspicious activities and are required to undertake due diligence on art trading for transactions valued at €10,000 and above, including explicitly in freeports. UK freeports must comply with these 5AMLD directives, and are therefore obliged to run customer due diligence (CDD) and report suspicious transactions to financial intelligence units.

However, according to evidence submitted by RUSI to the International Trade Committee's Inquiry on UK Freeports last May,[9] the UK government had yet to explicitly commit to the OECD's specific recommendation around freeports, [10] which covers practices like the vetting of businesses operating in the zones and identification of ultimate beneficial owners for fuller transparency on high-risk businesses, individuals and shipments. Without this commitment, criminals can easily circumnavigate CDD via shell companies and mule-like individuals acting on their behalf - and the country's freeports will remain exposed and vulnerable to TBML.

9. https://committees.parliament.uk/writtenevidence/5407/html/
10. https://www.oecd.org/governance/risk/recommendation-enhancing-transparency-free-trade-zones.htm

MITIGATING RISKS ASSOCIATED WITH FREEPORTS

It is vital to have a robust regulatory framework in place when establishing freeports in order to mitigate the aforementioned risks, the majority of which arise as a direct consequence of poor oversight and administrative procedures in certain free trade zones which have low transparency and weak inspection practices. The FATF's risk-based guidance and recommendations, which instruct authorities to carefully assess potential emerging risks in the AML/CFT sphere, must be closely followed when granting firms access to freeports. This includes thorough due diligence procedures checks on both companies as a whole, their beneficial owners and key executives, as well as regular spot checks by customs officials and law enforcement authorities.

Additionally, it is important that risks are not evaluated solely on the generalised and overall threat of financial crime but on the particular geographical location and business profile of the freeport too. Different areas and types of business activity pose unique threats and must be assessed and managed accordingly; where freeports operate in locations where crime rates are comparatively higher, the risk of criminal exploitation will be elevated and so inspections and countermeasures, informed by contextual data, should be tailored at an individual site level.

Regulators do not bear the sole burden of responsibility when it comes to mitigating freeport-associated risks - the private sector (including banks and businesses operating in and around freeports) can and must make significant contributions towards identifying and reporting criminal activity as part of their participation in international trade. Unfortunately, not all private actors are aware of the financial crime risks posed by freeports - or are equipped with the requisite knowledge of how to mitigate these risks or recognise suspicious activity. As such, raising general awareness of the potential threats associated with freeports is vital, as is the provision of appropriate information-sharing mechanisms to enable the reporting of any suspicious activities to relevant state authorities.

Close cooperation between authorities, regulators, Financial Intelligence Units, border forces and law enforcement agencies when dealing with Suspicious Activity Reports (SARs) is essential to broadening and deepening the body of knowledge around freeports and the role they play in facilitating illicit activities, and ensuring this is shared as widely and as effectively as possible. A willingness on the part of UK authorities to listen to and implement expert recommendations and guidance, and continuously evaluate the financial crime risks posed by freeports, is vital to their successful and compliant operation.

CONCLUSION

Freeports can enable financial crime by facilitating the concealment of goods, the protection of beneficial owners' identities and the laundering of money through trade activities, with lower than usual risk of detection. With the UK's recent plans to establish eight freeports, comprehensive frameworks must be put in place to ensure that risks are managed in the new zones. Companies that will operate in the freeports must ensure they are complying with 5AMLD requirements and any other guidance and recommendations authorities may yet decide to follow or implement. Customer due diligence for freeport-related business will be a must and this is where Themis can help.

Our dedicated investigations team can map out the risk that customers may pose to your business and trace beneficial ownership to give you a more transparent view of relevant actors and structures. As a business setting up in a freeport, it is also imperative that your anti-financial crime governance framework and risk management processes are robust and adhered to. Our online Themis Anti-Financial Crime Rating self-assessment diagnostic can support you by taking the pulse of your current controls and making recommendations to rectify any discerned gaps. Get in touch with a member of our team to talk through your specific requirements.

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