

# A Critical Look at the Current International Response to Combat Trade- Based Money Laundering: The Risk- Based Customs Audit as a Solution

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## INTRODUCTION

Money laundering<sup>1</sup> continues to pose a significant threat to countries and financial systems around the world.<sup>2</sup> It is a fundamental enabler of criminal groups<sup>3</sup> and is closely related to terrorism financing.<sup>4</sup> Although terrorism financing and money laundering, frequently carried out by drug smugglers,<sup>5</sup> are distinct activities, both raise similar concerns and use many of the same techniques to exploit vulnerabilities in countries' financial systems.<sup>6</sup> These activities threaten the very foundation "of financial institutions and systems, discourage foreign investment, and distort international capital flows."<sup>7</sup> Significantly, money laundering is the financial livelihood of criminal groups, and therefore enables these groups' violent and harmful activities.<sup>8</sup>

Estimates of money laundering activity worldwide run from \$590 billion to \$1.5 trillion annually.<sup>9</sup> The lower amount equates to the gross domestic product of an average-sized European country.<sup>10</sup> The full magnitude of global money laundering, however, is largely unknown as it is extremely difficult to quantify.<sup>11</sup> Not surprisingly, jurisdictions that do not closely regulate their financial systems or provide for oversight are particularly attractive to money launderers because these lax regulations enable large amounts of funds to be moved without detection.<sup>12</sup>

The international trade system is susceptible to money launderers taking advantage of trade import and export transactions through trade-based money laundering (TBML).<sup>13</sup> One TBML system, the Black Market Peso Exchange, facilitates the movement of \$5 billion in drug proceeds per year from the United

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1. The International Monetary Fund (IMF) defines money laundering as a "process by which the illicit source of assets obtained or generated by criminal activity is concealed to obscure the link between the funds and the original criminal activity." INTERNATIONAL MONETARY FUND, THE IMF AND THE FIGHT AGAINST MONEY LAUNDERING AND THE FINANCING OF TERRORISM 1 (2012), available at <http://www.imf.org/external/np/exr/facts/pdf/aml.pdf> [hereinafter INTERNATIONAL MONETARY FUND].

2. FINANCIAL ACTION TASK FORCE, GLOBAL MONEY LAUNDERING & TERRORIST FINANCING THREAT ASSESSMENT: A VIEW OF HOW AND WHY CRIMINALS AND TERRORISTS ABUSE FINANCES, THE EFFECT OF THIS ABUSE AND THE STEPS TO MITIGATE THESE THREATS para. 2 (2010), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/Global%20Threat%20assessment.pdf> [hereinafter FATF GTA].

3. *Id.* para. 28.

4. INTERNATIONAL MONETARY FUND, *supra* note 1, at 1 (explaining that money laundering and terrorism financing "exploit the same vulnerabilities in financial systems").

5. *See* FATF GTA, *supra* note 2, paras. 8–10 (summarizing the main sources of terrorism financing and money laundering, which include drug smuggling).

6. INTERNATIONAL MONETARY FUND, *supra* note 1, at 1.

7. *Id.*

8. FATF GTA, *supra* note 2, annex C, at 65–66, (discussing some of the harms associated with criminal and terrorist activity, including higher risk of physical violence, drug abuse, kidnapping, corruption of governments, and exacerbated failure of states).

9. *Money Laundering FAQ*, FINANCIAL ACTION TASK FORCE, <http://www.fatf-gafi.org/pages/faq/moneylaundering/#howmuchmoneyislaunchedperyear> (last visited Sept. 2, 2012).

10. *See id.* (noting that "the lower figure was roughly equivalent to the value of the total output of an economy the size of Spain").

11. *See* FATF GTA, *supra* note 2, para. 18 ("The GTA does not attempt to quantify the value and volume of ML/TF activity due to the lack of reliable and consistent statistics at a global level.").

12. *See id.* para. 35 (acknowledging that the existence of vulnerabilities or weaknesses in jurisdictional monitoring systems make them attractive for money launderers to use).

13. *Id.* para. 116.

States to Colombia.<sup>14</sup> TBML is defined as “the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illegal origins or finance their activities.”<sup>15</sup> Inherent weaknesses in the trade system, including considerable volume of trade flow and the ability of money launderers to integrate the proceeds into legitimate businesses, results in large-scale laundering over the long term.<sup>16</sup> Additionally, the nature of the trade system allows criminals<sup>17</sup> to separate themselves from the money laundering process.<sup>18</sup> This makes it even more difficult for law enforcement officials to conduct successful investigations into the origins of the activity.<sup>19</sup>

Traditionally, countries aimed anti-money laundering (AML) and counter-terrorism financing (CFT) efforts in both the public and private sectors at financial institutions.<sup>20</sup> As a result, there is comparatively less knowledge and education concerning TBML. This makes the trade system an increasingly attractive means for criminals to transfer their illicit proceeds.<sup>21</sup> Additionally, inherent weaknesses in the trade system itself, including volume of trade and complexity of the system, make it easier for criminals to disguise their transactions and evade enforcement.<sup>22</sup>

This Note will discuss the problems associated with TBML, particularly focusing on customs misrepresentation—the most prevalent type of TBML. It will explore the current regimes that exist to combat TBML and critically examine their strengths and weaknesses. Finally, a new solution will be proposed to combat the problem utilizing the Risk-Based Customs Audit, which balances the risks of TBML with the limited resources at countries’ disposal.

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14. U.S. DEP’T OF THE TREASURY ET AL., U.S. MONEY LAUNDERING THREAT ASSESSMENT 41 (2005), available at <http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/mlta.pdf> [hereinafter U.S. ML THREAT ASSESSMENT 2005].

15. FATF GTA, *supra* note 2, para. 117.

16. *Id.* paras. 123–25.

17. By “criminals,” this Author refers to both criminal and terrorist groups for simplicity, although the two types of groups are certainly different in some respects.

18. See FATF GTA, *supra* note 2, para. 124 (“Proceeds can be integrated into otherwise legitimate businesses which are involved in trade. The predicate offence and the individuals involved in them thus remain distanced from the activity.”).

19. U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 41.

20. FATF GTA, *supra* note 2, para. 126.

21. *Id.*; see also *A Current Assessment of Money Laundering and Terrorist Financing Threats and Countermeasures: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 33 (2006) (statement of Kevin Delli-Colli, Deputy Assistant Dir., Fin. Trade Investigations Div., Office of Investigations, U.S. Immigration & Customs Enforcement, U.S. Dep’t of Homeland Sec.), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109\\_senate\\_hearings&docid=f:39713.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_senate_hearings&docid=f:39713.pdf) [hereinafter *Hearing*] (“A number of the money laundering trends we have developed in response to the Bank Secrecy Act and the robust anti-money laundering programs instituted by the U.S. financial industry. As a result, criminal organizations are increasingly forced to resort to bulk cash smuggling, trade-based money laundering, and other schemes to move their illegal proceeds.”).

22. FATF GTA, *supra* note 2, para. 127.

## I. DISCUSSION OF THE PROBLEM: TYPES OF TRADE-BASED MONEY LAUNDERING

TBML takes a variety of forms and varies from basic systems to complex schemes that are extremely difficult to detect. The Financial Action Task Force (FATF), an intergovernmental organization created to assist countries in combating money laundering,<sup>23</sup> has recognized three specific types of TBML: (1) customs misrepresentation, (2) legitimate trade used to move value,<sup>24</sup> and (3) carousel fraud.<sup>25</sup> Sophisticated criminal groups combine different aspects of these more basic types into integrated channels and complex systems.<sup>26</sup> For example, the *hawala* system<sup>27</sup> uses TBML, as does the Black Market Peso Exchange,<sup>28</sup> which is the largest known system of TBML in the Americas. This Note will focus on one general type of TBML: customs misrepresentation.<sup>29</sup>

Customs misrepresentation through distortion of customs invoices is one of the most common forms of TBML globally.<sup>30</sup> The main purpose of customs misrepresentation is to disguise proceeds from illegal activity.<sup>31</sup> It can be carried out

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23. *About the FATF*, FINANCIAL ACTION TASK FORCE, [http://www.fatf-gafi.org/pages/0,3417,en\\_32250379\\_32236836\\_1\\_1\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236836_1_1_1_1_1_1,00.html) (last visited Mar. 14, 2012) (“The Financial Action Task Force (FATF) is an intergovernmental body established in 1989 by the Ministers of its Member Jurisdictions. The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system.”).

24. This Note will not discuss this type of TBML in detail, but it is important to note that this is also a type of TBML for countries to keep in mind when designing regulatory or administrative responses to TBML. The FATF describes this type of TBML as follows: “In this case, debts incurred with legitimate companies are placed under control of the money launderer. These debts are then settled using value received from criminal groups, mostly located in third countries. The company may not be aware of the true source of the funds used to settle the debts.” FATF GTA, *supra* note 2, para. 118.

25. *Id.* para. 119. This “type of TBML relates to laundering associated with value added tax (VAT)” and may or may not involve the actual movement of goods. *Id.* See generally FINANCIAL ACTION TASK FORCE, LAUNDERING THE PROCEEDS OF VAT CAROUSEL FRAUD (2007), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/Laundering%20the%20Proceeds%20of%20VAT%20Caroussel%20Fraud.pdf> [hereinafter FATF CAROUSEL FRAUD] (describing carousel fraud in detail).

26. FINANCIAL ACTION TASK FORCE, TRADE BASED MONEY LAUNDERING 7 (2006), available at [http://www.ctif-cfi.be/website/images/EN/typo\\_fatf/TBML.pdf](http://www.ctif-cfi.be/website/images/EN/typo_fatf/TBML.pdf) [hereinafter FATF TBML REPORT].

27. *Hearing*, *supra* note 21, at 68 (statement of Kevin Delli-Colli, Deputy Assistant Dir., Fin. Trade Investigations Div., Office of Investigations, U.S. Immigration & Customs Enforcement, U.S. Dep’t of Homeland Sec.) (“Alternative remittance systems, such as *hawalas*, have also long utilized trade to balance payments between *hawaladars*.”).

28. *Id.* at 48 (prepared statement of Stuart Levey Under Sec’y, Office of Terrorism & Fin. Intelligence, U.S. Dep’t of the Treasury) (“Some of the largest and most complex methods of money laundering harness trade into and out of the United States. Trade-based money laundering takes many forms including the Black Market Peso Exchange, which poses a particular challenge to law enforcement because it separates the crime from the cash early in the money laundering process. Under this scheme, drug dealers are able to hand off their illicit dollars in the United States to professional money launderers, who make clean currency available in Colombia or elsewhere.”); U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 41 (“The most common method of trade-based money laundering in the Western Hemisphere is the Black Market Peso Exchange (BMPE), in which Colombian drug traffickers swap illicit dollars in the United States for clean pesos in Colombia.”).

29. The term “customs misrepresentation” is a term unique to this Author to describe TBML through distortion of customs invoices.

30. FATF TBML REPORT, *supra* note 26, at 5.

31. *Id.* at 1.

through price misrepresentation with over- or underpriced invoices.<sup>32</sup> In addition, “the quality or quantity of the goods can be misrepresented.”<sup>33</sup> The basic techniques of customs misrepresentation include: (1) multiple invoices, (2) over- and underpricing, (3) false descriptions, and (4) over- and undershipment.<sup>34</sup> In order to understand customs misrepresentation, it is helpful to utilize some practical examples:

*Example 1:* Price Distortion (also known as the over- and underpricing of invoices): Group A wants to move \$5 million (the proceeds of illegal activities) to Group B. Group A purchases 500 diamond rings for \$10,000 each. Then Group A exports the 500 rings to Group B for \$10 each. Group B is able to sell the rings for \$5 million.<sup>35</sup>

*Example 2:* Undervaluing (also known as misrepresenting or providing false descriptions of the quality of goods): Customs agencies can generally only see one side of a trade transaction, and money launderers use this to their advantage.<sup>36</sup>

For example, if a U.S. exporter sends \$1 million dollars worth of computers to Brazil, U.S. customs officers do not know what is being reported upon entry to Brazil. A Brazilian importer in collusion with the exporter could easily change the paperwork to reflect the value of shipment as \$500,000. This would allow the Brazilian importer to justify a reduced payment of \$500,000 to the U.S. exporter, transferring \$500,000 additional dollars in value to Brazil.<sup>37</sup>

If this transferred value represents illicit proceeds (e.g., to fund terrorist activities or as part of a drug scheme), then it is considered money laundering.

Criminal organizations employ multiple techniques in TBML schemes.<sup>38</sup> Any approach to combat customs misrepresentation must take all of these different techniques into account.

In addition to the individual risks that customs misrepresentation creates for the trade system, TBML in general poses significant problems for international trade. These problems include undermining the stability of the financial sector and countries' borders, threatening the credibility of the trade system, and manipulating the trade system in order to avoid paying duties, tariffs, and taxes, thereby causing

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32. *Id.* at 4.

33. FATF GTA, *supra* note 2, para. 117, at 29.

34. FATF TBML REPORT, *supra* note 26, at 4.

35. Diamonds and precious gems are frequently used in money laundering activities to transfer value. U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 43. This is due to the fact that many times it is difficult to trace the source of where the diamonds are mined, and “[e]ven when diamonds are transported openly, it is relatively easy to mislabel the quality/value of a diamond for money laundering purposes.” *Id.*

36. U.S. IMMIGRATION & CUSTOMS ENFORCEMENT, *Homeland Security Investigations: Trade Transparency Unit*, VVI:3 THE CORNERSTONE REPORT 2 (Winter 2011), available at <http://www.ice.gov/doclib/news/library/reports/cornerstone/cornerstone7-3.pdf> [hereinafter CORNERSTONE REPORT 2011].

37. *Id.* at 2–3.

38. FATF TBML REPORT, *supra* note 26, at 7.

governments to lose legitimate revenue.<sup>39</sup> Certain countries and regions are more vulnerable than others to TBML. For example, Free Trade Zones are particularly susceptible to TBML due to the lack of oversight, transparency, or an integrated system for sharing trade data.<sup>40</sup>

## II. A CRITICAL LOOK AT CURRENT ATTEMPTS TO COMBAT TRADE-BASED MONEY LAUNDERING

In order to understand the difficulties of implementing an effective solution to target TBML, it is necessary to discuss the strengths and criticisms of the current attempts to combat TBML. This section first examines recommendations from the Financial Action Task Force (FATF). It then analyzes the current response from individual countries, particularly focusing on two distinct approaches: those of the United States and Australia.

### A. *The Financial Action Task Force Response*

In 2008, the FATF published *Best Practices on Trade Based Money Laundering*, (*FATF Best Practices*) which offers recommendations on steps that countries can take to effectively combat TBML.<sup>41</sup> While the paper does offer some helpful recommendations, it is only a small first step in addressing this complex problem. First, the FATF recognizes that one of the most basic problems in combating TBML is a lack of awareness and training among competent authorities.<sup>42</sup> It suggests as one possible solution that “in order to raise awareness and build expertise,” countries could incorporate TBML into existing AML training programs.<sup>43</sup> For countries with fewer resources available to combat TBML, this seems like an attractive option. This approach is too weak, however, and may incentivize countries to only take this minimum step. In other words, countries may choose to incorporate information regarding TBML into existing AML training programs instead of undertaking meaningful investigations into effective responses for specific threats in their home countries. Some governments, especially in countries with more limited resources, will take this minimum step in order to give the appearance to the international community that their countries are targeting TBML without actually tackling the problem in a meaningful way. This is especially problematic because countries have developed existing AML initiatives with the financial sector, not the trade sector, in mind. Hence, solely incorporating TBML education into existing programs will not

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39. FATF GTA, *supra* note 2, para. 121–22.

40. FINANCIAL ACTION TASK FORCE, MONEY LAUNDERING VULNERABILITIES OF FREE TRADE ZONES para. 54 (2010), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20vulnerabilities%20of%20Free%20Trade%20Zones.pdf> For example, in the United States, “[w]hen U.S.-based manufacturers import parts and materials outside of a Foreign Trade Zone (FTZ) [also known as a Free Trade Zone], they pay import duties based on the value of the finished product rather than the value of the component parts. Operating in an FTZ allows manufacturers to defer, reduce, or even eliminate U.S. Customs duties.” U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 42–43.

41. FINANCIAL ACTION TASK FORCE, BEST PRACTICES PAPER ON TRADE BASED MONEY LAUNDERING (2008), available at <http://www.fatf-gafi.org/media/fatf/documents/recommendations/BPP%20Trade%20Based%20Money%20Laundering%202012%20COVER.pdf> [hereinafter FATF BEST PRACTICES].

42. *Id.* para. 11.

43. *Id.*

train the authorities who would be the most effective in combating the problem (e.g., customs agents or employees of similar agencies). For example, the 2006 FATF report on TBML acknowledged that out of thirty-six countries asked to complete a survey, only one-third had training in place for customs agents on TBML.<sup>44</sup> The *FATF Best Practices* itself identifies multiple agencies whereby countries would benefit from providing TBML training.<sup>45</sup> These include: “the staff of trade authorities,<sup>46</sup> investigative authorities, customs agencies, tax authorities, the financial intelligence unit, prosecutorial authorities, [and] banking supervisors.”<sup>47</sup> The FATF identifies “misuse of the trade system as one of the *main methods* by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the formal economy” (emphasis added).<sup>48</sup> There must be higher expectations for the international community to defend against one of the main methods of illicit movement of money than by merely requiring training materials to be inserted into programs that are already in place to combat other types of money laundering. TBML is a distinctive form of money laundering and poses unique threats.<sup>49</sup> Therefore, training programs on TBML should be focused instead of grouped together with other forms of money laundering.

The FATF suggestions for financial and trade data analysis and techniques are more effective. These suggestions seem particularly helpful for customs misrepresentation. They include, among others, recommendations such as:

- a) Comparing domestic and foreign import/export data to detect discrepancies in the Harmonized Tariff Schedule, country of origin, manufacturer, importer/exporter, ultimate consignee, broker, unit price, commodity activity by time period, and port of import/export.
- b) Analysing financial information collected by the FIU to identify patterns of activity involving the importation/exportation of currency, deposits of currency in financial institutions, reports of suspicious financial activities, and the identity of parties to these transactions.
- c) Examining cargo movements through the comparison of import/export documentation between two countries [sic] to verify that the data reported to one country’s authorities matches the data reported to the other country’s authorities.
- d) Examining domestic import data with an automated technique, such as Unit Price Analysis, to compare the average unit price for a

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44. FATF TBML REPORT, *supra* note 26, at 21.

45. See FATF BEST PRACTICES, *supra* note 41, para. 12 (“[C]ountries are encouraged to provide training on TBML/FT techniques to the staff of trade authorities, investigative authorities, customs agencies, tax authorities, the financial intelligence unit, prosecutorial authorities, banking supervisors and any other authorities that the country identifies as being relevant to the fight against TBML/FT . . .”).

46. “[T]rade authorities refers to the authorities who are responsible for collecting, analysing and/or storing trade data.” *Id.* para. 7.

47. *Id.* para. 12.

48. *Id.* para. 1.

49. See generally FATF TBML REPORT, *supra* note 26 (comparing TBML and adequate preventative measures to other money laundering techniques).

particular commodity and identify traders who are importing commodities at a substantially higher or lower price than the world market.

- e) Comparing information such as the origin, description and value of the goods, particulars of the consignee and consignor, and the route of shipment with intelligence information in existing databases to detect any irregularities, targets or risk indicators . . . .<sup>50</sup>

Recommendation (d) regarding “Unit Price Analysis” could be an effective mechanism for combating the over- and underpricing of goods in customs invoice misrepresentation. Additionally, a combination of recommendations (c), (d), and (e) bears a resemblance to a computer-based system used in the United States to detect TBML (discussed later in this section). Although the Unit Price Analysis combined with a data comparison between two countries may be a plausible solution for some types of goods (i.e., easy-to-value goods that have a readily identifiable market price), this type of analysis will be less effective for other types of goods such as rare carpets, antiques, or pieces of artwork.<sup>51</sup> High-priced items, such as works of art, present valuation difficulties because of their limited markets and inherently speculative or uncertain true values.<sup>52</sup>

In addition to the recommendations above, there are general recommendations, such as making publications available containing information on TBML and holding interagency conferences and seminars.<sup>53</sup> Countries are encouraged to conduct further study nationally and in partnership with foreign countries regarding the effects and new trends of TBML.<sup>54</sup> The *FATF Best Practices* suggests that countries “develop a domestic mechanism to link the work of authorities responsible for collecting, analysing and storing trade data with authorities responsible for investigating money laundering and terrorist financing.”<sup>55</sup> This information could be facilitated by using mechanisms such as “memoranda of understanding [i.e., to address legal barriers and facilitate information sharing between relevant agencies], information sharing agreements, the use of liaison officers[,] . . . the establishment of multi-agency task forces” or the use of a specialized unit, such as the Trade Transparency Unit in the United States, to analyze trade data and compare discrepancies.<sup>56</sup> In instances “[w]here domestic privacy and data protection laws

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50. FATF BEST PRACTICES, *supra* note 41, para. 13.

51. See generally Hannah Purkey, *The Art of Money Laundering*, 22 FLA. J. INT’L L. 111, 122–28 (2010) (discussing the problems associated with how criminals use art to launder money and arguing that customs agents are not qualified to detect this type of laundering of illicit funds).

52. FATF GTA, *supra* note 2, para. 189.

53. See FATF BEST PRACTICES, *supra* note 41, para. 16 (“To ensure that a sufficiently wide audience benefits from awareness raising and training on TBML/FT, countries are encouraged to consider using a combination of delivery methods, such as: offering or participating in conferences, seminars, workshops and other events, including those organised by the private sector; making presentations; holding inter-agency meetings; developing internet-based learning tools (e-learning); publishing guidance; posting information on the websites of competent authorities; including relevant information in the annual reports or other publications of competent authorities; or sending relevant materials to contacts directly.”).

54. *Id.* paras. 19, 26.

55. *Id.* para. 20.

56. *Id.* para. 22; see also *Trade Transparency Unit*, U.S. IMMIGRATION & CUSTOMS ENFORCEMENT, <http://www.ice.gov/trade-transparency/> (last visited Sept. 15, 2012) [hereinafter *Trade Transparency Unit*] (explaining the role of specialized Trade Transparency Units in the United States and foreign affiliates).



inhibit the dissemination of data at the domestic level, countries are encouraged to undertake studies to examine the possible effects of this information.<sup>57</sup> Mechanisms in place that would “redact sensitive or identifying information from trade data,” thereby allowing the data to be used to analyze trade trends or to share information with other countries, would also be helpful.<sup>58</sup>

Finally, the *FATF Best Practices* emphasizes that countries should develop gateways and mechanisms for sharing trade data with other foreign counterparts.<sup>59</sup> A single database that allows the participating countries to share trade data and is subject to data collection safeguards could be useful.<sup>60</sup> This step could be important in understanding the global magnitude of the problem and developing cross-national solutions. By identifying the impact on affected countries, many countries may be more receptive to a cooperative commitment of resources to address TBML. This could be critical because various governments and institutions are reluctant to participate without knowledge of the magnitude of the TBML problem.

In addition to the *FATF Best Practices*, the FATF is well-known for the *FATF 40 Recommendations (40 Recommendations)*, the international standard for combating money laundering. One hundred and thirty countries endorsed these recommendations, which include necessary procedures for national criminal justice and regulatory systems, objectives for financial institutions and certain other businesses and professions, and provisions for cooperation on an international level.<sup>61</sup> The *40 Recommendations* were amended in 2003 and were complemented by nine “Special Recommendations” specifically targeted toward terrorist financing (collectively the 40 + 9 Recommendations).<sup>62</sup> These recommendations have been highly effective, resulting in implementation of a large number of domestic mechanisms that comply with the FATF recommendations and endorsement by over 180 jurisdictions as of 2010.<sup>63</sup> Surprisingly, despite the FATF’s repeated recognition of the threat of TBML for the international community, not one of the 40 + 9 Recommendations specifically addresses TBML.<sup>64</sup> Recently, in February 2012, the FATF released a revised version of the recommendations (2012 FATF Recommendations).<sup>65</sup> The new revisions address emerging threats, elaborate on

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57. FATF BEST PRACTICES, *supra* note 41, para. 26.

58. *Id.* para. 27.

59. *Id.* para. 30.

60. *Id.*

61. FINANCIAL ACTION TASK FORCE, FATF 40 RECOMMENDATIONS 2 (2003), available at <http://www.fatf-gafi.org/media/fatf/documents/FATF%20Standards%20-%2040%20Recommendations%20rc.pdf> [hereinafter FATF 40 RECOMMENDATIONS].

62. *Id.*; FINANCIAL ACTION TASK FORCE, FATF IX SPECIAL RECOMMENDATIONS (2001), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/FATF%20Standards%20-%20IX%20Special%20Recommendations%20and%20IN%20rc.pdf> [hereinafter FATF IX SPECIAL RECOMMENDATIONS].

63. FATF GTA, *supra* note 2, at 3.

64. *See generally* FATF 40 RECOMMENDATIONS, *supra* note 61; FATF IX SPECIAL RECOMMENDATIONS, *supra* note 62 (stating detailed recommendations for countries regarding AML and steps to combat terrorist financing, but not specifically mentioning TBML).

65. FINANCIAL ACTION TASK FORCE, THE FATF RECOMMENDATIONS: INTERNATIONAL STANDARDS ON COMBATING MONEY LAUNDERING AND THE FINANCING OF TERRORISM & PROLIFERATION (2012), available at [http://www.fatf-gafi.org/media/fatf/documents/recommendations/dfs/FATF%20Recommendations%20\(approved%20February%202012\)%20reprint%20May%202012%20web%20version.pdf](http://www.fatf-gafi.org/media/fatf/documents/recommendations/dfs/FATF%20Recommendations%20(approved%20February%202012)%20reprint%20May%202012%20web%20version.pdf).

existing obligations, and integrate many of the Special Recommendations regarding terrorist financing throughout the 2012 FATF Recommendations, thereby “obviating the need for the Special Recommendations.”<sup>66</sup> The revised 2012 FATF Recommendations still do not address TBML.<sup>67</sup>

In order to monitor the progress of implementation of the *40 Recommendations* in member countries, the FATF established certain mechanisms.<sup>68</sup> These mechanisms include a mutual evaluation program conducted by the FATF, which contains detailed country reports and evaluations by the International Monetary Fund.<sup>69</sup> Also, in 2000, the FATF implemented a series of reports and started placing countries on a Non-Cooperative Countries and Territories (NCCT) list if they did not meet the standards in the *40 Recommendations*.<sup>70</sup> In order to be removed from the list, countries must enact laws and regulations in accordance with international standards to overcome deficiencies noted in the NCCT report.<sup>71</sup> Of the fifteen jurisdictions that were initially identified as NCCTs, all have been de-listed.<sup>72</sup> If the FATF added a recommendation regarding TBML, an assessment of a country’s implementation of mechanisms regarding TBML could be included in a country report and as one of the criteria for the NCCT list.

Some academics have argued that there should be greater incorporation between the *FATF Best Practices* and the FATF recommendations.<sup>73</sup> For example, Delston and Walls would add a recommendation that would require “traders,” as

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66. *Id.* at 8.

67. *See id.* (listing the updated FATF Recommendations, which have detailed recommendations for combating terrorist financing and money laundering, but still do not specifically address TBML).

68. *See Mutual Evaluations*, FINANCIAL ACTION TASK FORCE, <http://www.fatf-gafi.org/topics/mutualevaluations/> (last visited Feb. 18, 2013 Mar. 13, 2012) (explaining that the FATF conducts peer reviews of members and providing links to the individual reports); *see also Hearing, supra* note 21, at 63 (prepared statement of Michael Morehart, Chief, Terrorist Fin. Operations Section, Fed. Bureau of Investigation) (“All member countries have their implementation of the forty recommendations monitored through a two-pronged approach: An annual self-assessment exercise and the more detailed mutual evaluation procedure.”).

69. *See* FINANCIAL ACTION TASK FORCE, AML/CMT EVALUATIONS AND ASSESSMENTS HANDBOOK FOR COUNTRIES AND ASSESSORS 4, 18, 44 (2009), *available at* <http://www.fatf-gati.org/media/fatf/documents/reports/Handbook%20for%20assessors.pdf> (stating that the FATF handbook is for teams taking part in an IMF assessment and that authorities of the country completing the questionnaire may refer to “reports, assessments, or reviews” published by the IMF); *see, e.g.*, FINANCIAL ACTION TASK FORCE, MUTUAL EVALUATION REPORT: ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: AUSTRIA (2009), *available at* <http://www.fatf-gati.org/media/fatf/documents/reports/mer/MER%20Austria%20full.pdf> (providing a detailed country evaluation of the AML/CFT in Austria by the International Monetary Fund, among others); FINANCIAL ACTION TASK FORCE, MUTUAL EVALUATION REPORT: ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: STATE OF KUWAIT (2011), *available at* <http://www.fatf-gati.org/media/fatf/documents/reports/mer/Kuwait%20MER%20full%20report.pdf> (providing a detailed country evaluation of the AML/CFT in Kuwait by the International Monetary Fund, among others).

70. FINANCIAL ACTION TASK FORCE, ANNUAL REVIEW OF NON-COOPERATIVE COUNTRIES AND TERRITORIES 2006–2007: EIGHTH NCCT REVIEW 2–3 (2007), *available at* <http://www.fatf-gafi.org/media/fatf/documents/reports/2006%202007%20NCCT%20ENG.pdf> [hereinafter FATF ANNUAL REVIEW OF NCCT].

71. *Id.* at 11.

72. *Id.* at 13.

73. *See, e.g.*, Ross S. Delston & Stephen C. Walls, *Reaching Beyond Banks: How to Target Trade-Based Money Laundering and Terrorist Financing Outside the Financial Sector*, 41 Case W. Res. J. Int’l L. 85, 88–89 (2009) (discussing the proposition that “for any new Recommendation to be effective, the FATF needs to go further than it has in the past”).

defined in the *FATF Best Practices*, to implement customer due diligence and record keeping, Suspicious Activity Reports, and similar protocols.<sup>74</sup> This is similar to what was already required of financial institutions and certain “non-financial businesses and professions” under current anti-money laundering and counter-terrorism financing (AML/CFT) efforts in the 40 + 9 Recommendations.<sup>75</sup> Customer due diligence would require, among other things, identifying and verifying customer identity, assessing respondent institutions’ money laundering and terrorist controls, and maintaining detailed records of all transactions for at least five years.<sup>76</sup> Suspicious Activity Reports should require, by law or regulation, reporting of *any* suspicious transaction.<sup>77</sup> These requirements would impose significant regulation on many non-financial institutions, as the term “trader” in the *FATF Best Practices* encompasses importers and exporters, shippers, air couriers, and any company that operates principally to import and export goods.<sup>78</sup> Alternatively, Delston and Walls suggest a recommendation that would require “countries . . . to adopt detection mechanisms, enhanced scrutiny for trade transactions” and other similar measures.<sup>79</sup>

However, Delston and Walls’ approach seems to conflict with the *FATF Best Practices* themselves, which emphasize the importance of “ensuring that legitimate trading activities are not unreasonably hindered or obstructed” and “ensuring that regulatory considerations are addressed in a way that does not impose unnecessary financial and administrative burdens on reporting entities.”<sup>80</sup> There needs to be more of a balance. This would entail a stronger commitment by the FATF towards TBML by including a special provision targeting TBML in the 2012 FATF Recommendations, while at the same time keeping in mind that this recommendation needs to be carefully tailored so as to stay in line with the FATF goal of not hindering legitimate trade between countries.

### B. Individual Country Response

To date, individual countries have done very little to address TBML. The United States and Australia present two opposite sides of the spectrum regarding the amount and types of efforts in place to combat TBML.

Australia has taken a very limited regulatory approach to TBML. In response to an unfavorable report by the FATF that Australia was not complying with the 40 + 9 Recommendations, Australia introduced the Anti-Money Laundering and Counter-Terrorism Financing Act (AML/CTF Act) in 2006 to regulate the financial sector and related businesses.<sup>81</sup> There has been discussion that this Act may be

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74. *Id.* at 88–89.

75. *Id.* at 94.

76. FATF 40 RECOMMENDATIONS, *supra* note 61, at 5–7.

77. *Id.* at 8.

78. *See* FATF BEST PRACTICES, *supra* note 41, para. 10 (“The term *trader* refers to anyone who facilitates the exchange of goods and related services across national borders, international boundaries or territories.”).

79. Delston & Walls, *supra* note 73, at 107.

80. *Id.* at 114.

81. CLAIRE SULLIVAN & EVAN SMITH, TRADE-BASED MONEY LAUNDERING: RISKS AND REGULATORY RESPONSES 22 (Austl. Inst. of Criminology ed., 2011), available at <http://www.aic.gov.au/>

extended to other sectors such as real estate, accounting, and law, but there are no current plans to extend it to trade.<sup>82</sup>

There are concerns with extending the AML/CTF Act to trade in Australia. The main concerns are that it would be too costly and impose too high of a budgetary and regulatory burden; that there is lack of research on the topic, particularly as to how large of a threat TBML is for Australia; and that traders lack sophisticated mechanisms that were present in financial institutions for implementing this type of compliance.<sup>83</sup> Alternatively, the Australian approach, at least presently, is to comply with the FATF recommendations by extending their current education and awareness training among regulated entities and government agencies to include information about TBML.<sup>84</sup> Additionally, Australia already collects trade data and has strict border and customs regulations that put it at a lesser risk to TBML than areas like the European Union with Free Trade Zones.<sup>85</sup>

Thus, Australia has chosen to take the narrower approach outlined in the *FATF Best Practices*. Specifically, it will emphasize education and awareness in an effort to minimize undue regulatory restrictions on business and trade until there is greater knowledge and information regarding the nature of TBML in Australia.<sup>86</sup> While it is understandable that Australia does not want to impose huge costs on its business and trade industries before taking further action to study the effects of TBML, this type of response is just the type of concern that was expressed in Section A of this Note. Because the FATF has offered this narrower education and awareness approach as a viable option for countries to combat TBML, it will not be surprising if more countries opt to take this less costly approach and leave development of further techniques to countries with greater resources, like the United States.

The approach taken by the U.S. Government to combat TBML closely resembles the ideas in the *FATF Best Practices*. This is not surprising, as representatives from both the U.S. Federal Bureau of Investigation and the U.S. Department of the Treasury have openly stated in Congressional hearings that they have taken leadership roles within the FATF.<sup>87</sup> Since 2004, the U.S. Immigration and Customs Enforcement (ICE) has been leading investigations on TBML in the United States through the establishment of the Trade Transparency Unit (TTU).<sup>88</sup> The TTU, operated by ICE, forms partnerships with TTUs in U.S. trading partner countries.<sup>89</sup> The TTU analyzes trade import and export data and trade information obtained from both the United States and partnership countries and searches for

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documents/A/0/3/%7BA03716CB-BFD3-46B3-93EC-66FD9D9029A7%7Drpp115.pdf [hereinafter AIC TBML REPORT].

82. *Id.* at 23.

83. *Id.* at 23–24.

84. *Id.* at 24.

85. *Id.* at iii, 25.

86. *Id.* at 26.

87. *Hearing, supra* note 21, at 48 (prepared statement of Stuart Levey, Under Sec’y, Office of Terrorism & Fin. Intelligence, U.S. Dep’t of the Treasury) (“[T]he United States, with Treasury as its head of delegation, has taken a leadership role in the Financial Action Task Force (FATF) to establish and promulgate international standards for combating money laundering and terrorist financing.”); *Id.* at 63 (prepared statement of Michael Morehart, Chief, Terrorist Fin. Operations Section, Fed. Bureau of Investigation) (“As it relates to international money laundering enforcement, the FBI is an active participant in the Financial Action Task Force (FATF).”).

88. *Trade Transparency Unit, supra* note 56.

89. *Id.*

anomalies using a computerized program called Data Analysis and Research for Trade Transparency System (DARTTS) (discussed below).<sup>90</sup> This enables relevant authorities to be able to see trade data declared at both the origin and destination of transactions.<sup>91</sup> The analysis seems to target customs misrepresentation, but also mentions carousel fraud as one of many red flags. The TTU official red flag indicators of TBML are:

- Payments to vendor made in cash by unrelated third parties,
- Payments to vendor made via wire transfers from unrelated third parties,
- Payments to vendor made via checks, bank drafts or postal money orders from unrelated third parties,
- False reporting, such as commodity misclassification, commodity over-valuation or under-valuation,
- Carousel transactions (the repeated importation and exportation of the same high-value commodity),
- Commodities being traded do not match the business involved,
- Unusual shipping routes or transshipment points,
- Packaging inconsistent with commodity or shipping method, and
- Double-invoicing.<sup>92</sup>

The TTU is an interagency initiative including “representative[s] of the customs service, financial intelligence unit, law enforcement agencies and, where applicable, the judiciary.”<sup>93</sup> The TTU is not aimed solely at TBML. It targets “money laundering, customs fraud, contra-band smuggling, and the evasion of duties and taxes.”<sup>94</sup> The likely effectiveness of the TTU is difficult to predict because of the many crimes it targets. On the one hand, these activities may be so related and interconnected that it only makes sense for one entity to target all of them together. This could be an advantage by lowering administrative start-up costs, particularly for countries that do not have knowledge or studies of the effect of TBML in their country and are therefore skeptical of spending high start-up costs on technology and

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90. *Id.*; *Hearing, supra* note 21, at 48 (prepared statement of Stuart Levey, Under Sec’y, Office of Terrorism & Fin. Intelligence, U.S. Dep’t of the Treasury) (“These units allow countries to compare import and export logs to uncover anomalies that may indicate money laundering, and represent a serious advance in our worldwide anti-money laundering efforts.”).

91. *Trade Transparency Unit, supra* note 56; *see also Hearing, supra* note 21, at 60 (prepared statement of E. Anthony Wayne, Assistant Sec’y for Econ. Affairs, U.S. Dep’t of State) (“The TTU’s will enable the [Triborder Area] countries and the [U.S. Government] to compare trade data declared at origin and destination of trade transactions . . .”).

92. *Trade Transparency Unit, supra* note 56.

93. *Hearing, supra* note 21, at 60 (prepared statement of E. Anthony Wayne, Assistant Sec’y for Econ. & Bus. Affairs, U.S. Dep’t of State).

94. CORNERSTONE REPORT 2011, *supra* note 36, at 3.

personnel solely to target TBML. On the other hand, by using TTUs to investigate all of these different crimes, it could be possible that their resources are being spread too thin. Many of the reports discussing the TTUs are unclear regarding allocation of resources to the different crimes or in what area most of the investigations are targeted.<sup>95</sup>

ICE uses a specialized computer program to aid in its TTU investigations called DARTTS, mentioned above.<sup>96</sup> In order to determine which trade transactions warrant further investigation, ICE investigators must first analyze and compare trade data from both importing and exporting countries in order to detect discrepancies or anomalies.<sup>97</sup> DARTTS is an automated system that makes this process more efficient.<sup>98</sup> DARTTS uses trade data from foreign governments and other federal agencies, including U.S. Customs and Border Enforcement, U.S. Department of the Treasury, and other similar agencies, as well as currency reports, Suspicious Activity Reports, and related forms.<sup>99</sup> Most of these agencies obtain data from individuals or institutions, such as banks, that are required to fill out import-export reports.<sup>100</sup> Once DARTTS identifies a statistically suspicious transaction, ICE agents examine the transaction to determine if further investigation is needed.<sup>101</sup> Otherwise stated, the first step in the investigative process is that DARTTS identifies suspicious transactions through an automated analysis, which searches for discrepancies or anomalies.<sup>102</sup> As a second step, after DARTTS identifies a suspicious transaction, ICE agents investigate further by using the TTU red flags mentioned above in order to determine if further investigation is warranted.<sup>103</sup>

What is most apparent about the DARTTS system is that it is automated. Like the Unit Price Analysis described by the *FATF Best Practices*, one of DARTTS' pervading weaknesses is that it would be very difficult for the program to identify hard-to-value goods if there were no discrepancy or anomaly in the import-export forms. This could incentivize launderers to resort to using hard-to-value goods to hide their funds in order to remain undetected. However, the system does save administrative costs, as it would be highly inefficient for ICE agents to analyze all the trade data by hand. Assuming that launderers are more likely to misrepresent the price of a good on one form (e.g., an export form), but not the other (e.g., an importer's form in another country), DARTTS may be quite effective in identifying TBML transactions, particularly when coordinated with further investigation by ICE agents looking for the TTU red flag indicators. Further study would be helpful in order to identify which types of goods and what types of TBML are most prevalent in certain regions so that the authorities can better target the crimes. Additionally, if

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95. See, e.g., FATF TBML REPORT, *supra* note 26, at 21; CORNERSTONE REPORT 2011, *supra* note 36, at 3; U.S. DEP'T OF HOMELAND SECURITY, PRIVACY IMPACT ASSESSMENT FOR THE DATA ANALYSIS & RESEARCH FOR TRADE TRANSPARENCY SYSTEM (DARTTS) 2 (2008), available at [http://www.dhs.gov/xlibrary/assets/privacy/privacy\\_pia\\_ice\\_dartts.pdf](http://www.dhs.gov/xlibrary/assets/privacy/privacy_pia_ice_dartts.pdf) [hereinafter PRIVACY IMPACT ASSESSMENT FOR DARTTS] (describing the crimes the TTUs target, but failing to mention the allocation of resources to the different crimes).

96. *Trade Transparency Unit*, *supra* note 56.

97. PRIVATE IMPACT ASSESSMENT FOR DARTTS, *supra* note 95, at 2.

98. *Id.*

99. *Id.* at 3–5.

100. *Id.* at 3.

101. *Id.* at 2.

102. *Id.*

103. PRIVATE IMPACT ASSESSMENT FOR DARTTS, *supra* note 95, at 2.

this automated system combined with certain red flags has led to successful investigations in the past, sharing this information with other trading partners would be one effective way to convince other countries to invest in the TTUs, so that the United States is not responsible for funding all the start-up costs as is the current situation.

The United States established the first foreign-based TTU in Colombia in 2005 to combat financial crimes, specifically the Black Market Peso Exchange.<sup>104</sup> Since that time, the United States also established TTUs in Brazil (2006), Paraguay (2007), Mexico (2008), and Argentina (2006), which have purportedly identified millions of dollars of lost government revenue.<sup>105</sup> For example, TTU investigations in Mexico have allegedly “resulted in the seizure of currency and contraband valued at approximately \$21 million last fiscal year. In fiscal year 2008 to date, TTU related investigations have resulted in more than 100 seizures totaling more than \$3.7 million.”<sup>106</sup> In 2010, with funding from the U.S. Department of State’s Bureau of International Narcotics and Law Enforcement Affairs, Panama became the newest link in the network of U.S. TTUs.<sup>107</sup> Some examples of work that the Panamanian TTU has accomplished include:

[T]he discovery of a network of banks and exchange houses that moved euros from Colombia, using Panamanian banks, to the U.S. and Europe; the use of harmonized tariff codes for perfumes, video gaming and precious metals to identify several companies in the [Colon Free Trade Zone] involved in commercial fraud and possible trade-based money laundering; and, information that reveals possible export tax incentive fraud.<sup>108</sup>

It is interesting to note, that although the report mentions TBML, it only states that there was possible TBML, and many other successes do not involve TBML at all.<sup>109</sup> It is unclear from these reports what resources from the TTU are allocated to TBML or how effective the TTUs are at combating TBML, specifically given that the TTUs target many different types of crime and do not solely target TBML. ICE claims that eventually it envisions a global network of TTUs, established with all U.S. trading partners, which would provide open exchange of information from all participating countries.<sup>110</sup> This is a very ambitious vision, especially as it looks like the U.S. agencies have been providing the start-up funding for all the TTUs currently in place.

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104. BUREAU FOR INT’L NARCOTICS & LAW ENFORCEMENT AFFAIRS, U.S. DEP’T OF STATE, INTERNATIONAL NARCOTICS CONTROL STRATEGY REPORT: VOLUME II MONEY LAUNDERING AND FINANCIAL CRIMES 83 (2011), available at <http://www.state.gov/documents/organization/156589.pdf> [hereinafter INT’L NARCOTICS CONTROL STRATEGY REPORT 2011].

105. *Id.* at 12, 69, 152; *Trade Transparency Unit Program to Combat Money Laundering*, EMBASSY OF THE U.S., BUENOS AIRES, ARG. (July 18, 2006), [http://argentina.usembassy.gov/evento\\_laundering.html](http://argentina.usembassy.gov/evento_laundering.html); *ICE Launches Trade Transparency Unit in Mexico City as Part of Bi-lateral Cooperation with Mexico Customs: ICE Opens Mexico City TTU To Combat and Eliminate Trade-Based Money Laundering Systems*, U.S. IMMIGRATION & CUSTOMS ENFORCEMENT (June 12, 2008), <http://www.ice.gov/news/releases/0806/080612mexicocity.htm> [hereinafter *TTU in Mexico City*].

106. *TTU in Mexico City*, *supra* note 105.

107. INT’L NARCOTICS CONTROL STRATEGY REPORT 2011, *supra* note 104, at 12.

108. *Id.* at 150.

109. *Id.*

110. *Trade-Based Money Laundering*, U.S. IMMIGRATION & CUSTOMS ENFORCEMENT,

One example of customs misrepresentation that TTUs are meant to target relates to the example of undervaluing goods in customs invoices described in Section 1 of this Note. In the example, Company A, in Country X, exported goods worth \$1 million to Company B, in Country Y. The launderers misrepresented the goods on the customs invoice, however, and imported at a value of \$500,000. The benefit of having a TTU in both Country X and Country Y is that both the importing and exporting countries will have the trade information, and, in theory, will be able to detect the discrepancies in the two different invoices. The picture becomes more complicated, however, when goods are exported first from countries that are not part of the TTU network. For example, Company C could export from Country Z, which is not part of the TTU network, who then sends the goods to Company A, in Country X, and then the goods finally end up with Company B, in Country Y. Because Country Z is not part of the TTU network, Country X is not able to tell if the goods were valued at the same price when they were exported as when they were imported. Unless all or most of the countries that frequently trade together are part of the TTU network, there is much room for sophisticated criminals to circumvent detection.

The U.S. approach has high start-up and administrative costs that make its system impractical in developing countries or countries where there is little known about the true effects of TBML.<sup>111</sup> In countries like Australia with limited study on the effects of TBML, the high start-up costs may not be justified by a significant enough problem.<sup>112</sup>

### III. THE RISK-BASED CUSTOMS AUDIT AS A SOLUTION TO TRADE-BASED MONEY LAUNDERING THROUGH CUSTOMS MISREPRESENTATION

This section proposes a new approach to combat TBML: the Risk-Based Customs Audit. Customs audits are used in many countries currently to target other trade-based crimes, such as tax evasion, but have not been used to target TBML.<sup>113</sup> First, this section will discuss justifications for this new approach to combat TBML and briefly describe how customs audits are used currently by some countries, using Korea as a model. Next, it will explain how countries can target TBML using a customs audit and why the Risk-Based Customs Audit is the best solution for combating TBML. Finally, the section will conclude with a discussion of possible challenges to the new approach.

Both the FATF and U.S. approaches to combat TBML make the implicit assumption that information sharing between countries is always superior; however, this may not necessarily be the case. For example, governments may not want to share trade information in fear that other foreign governments may be in collusion with money launderers and could use this information to circumvent actions being taken to combat TBML. Assuming that a country does not want to develop a TTU

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<http://www.ice.gov/cornerstone/money-laundering.htm> (last visited Mar. 14, 2012).

111. AIC TBML REPORT, *supra* note 81, at 2, 23–26.

112. *Id.* at 25–26.

113. See, e.g., CUSTOMS & TARIFF BUREAU, MINISTRY OF STRATEGY & FIN., KOREA CUSTOMS AND TARIFF 27 (2010), available at [http://idn.mofat.go.kv/kor/as/idn/images/res/2010\\_Korea\\_Customs\\_and\\_Tariff.pdf](http://idn.mofat.go.kv/kor/as/idn/images/res/2010_Korea_Customs_and_Tariff.pdf) [hereinafter KOREA CUSTOMS AND TARIFF] (“The purpose of [the] planned audit is to examine intensively the transactions of particular goods . . . in order to prevent tax evasion activities.”).



or similar information-sharing database, is a developing country without a large amount of available funds to allocate to combating TBML, or is a country that does not yet have enough information on the effects of TBML on its trade system to justify the expense involved with TTUs, what can the country do to protect itself? Although countries are not familiar with targeting money laundering through the trade system, they are used to targeting other types of trade-based crimes, including tax evasion<sup>114</sup> and “dumping.”<sup>115</sup> These crimes involve some of the same forms of customs misrepresentation that are used in TBML, including over- and under-invoicing (tax evasion)<sup>116</sup> and undervaluing of goods (dumping).<sup>117</sup> Implementing a customs audit system in order to accelerate customs clearance and target tax evasion is becoming fairly common globally, particularly in World Trade Organization member states.<sup>118</sup> The customs audit currently does not target TBML,<sup>119</sup> but as will be shown, the Risk-Based Customs Audit is a viable solution for countries to protect their borders from TBML.

#### A. Current Use of the Customs Audit to Target Tax Evasion

A customs audit “means the audit conducted by the customs on the basis of the account books and vouchers, customs declaration documentations or data, commercial documents and goods of the traders with the purpose [of] identify[ing] the authenticity and validity of the trade.”<sup>120</sup> Authority for countries to conduct these audits and access this information is usually granted under a national regulation or directive. For example, in the European Union, Article 78(2) of Regulation 2913/1992 (Community Customs Code) and Article 27 of Regulation 450/2008 (Modernised Customs Code) afford customs authorities the authorization to

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114. FATF TBML REPORT, *supra* note 26, at 2–3.

115. See *Anti-dumping*, WORLD TRADE ORGANIZATION, [http://www.wto.org/english/tratop\\_e/adp\\_e/adp\\_e.htm](http://www.wto.org/english/tratop_e/adp_e/adp_e.htm) (last visited Feb. 18, 2013) (defining dumping as occurring when “a company exports a product at a price lower than the price it normally charges on its own home market . . .”).

116. FATF TBML REPORT, *supra* note 26, at 2.

117. *Anti-dumping*, *supra* note 115.

118. The large group of countries that have implemented a customs audit system includes such diverse countries as the United States, Australia, Malaysia, New Delhi, and Papua New Guinea. See generally U.S. CUSTOMS & BORDER PROT., CBP TRADE STRATEGY: FISCAL YEARS 2009–2013 16 (2009), available at [http://www.cbp.gov/linkhandler/cgov/trade/trade\\_outreach/trade\\_strategy/cbp\\_trade\\_strategy.ctt/cbp\\_trade\\_strategy.pdf](http://www.cbp.gov/linkhandler/cgov/trade/trade_outreach/trade_strategy/cbp_trade_strategy.ctt/cbp_trade_strategy.pdf) [hereinafter U.S. CBP STRATEGY]; AUSTRALIAN CUSTOMS SERV., A GUIDE TO CUSTOMS COMPLIANCE AUDITS (2007), available at <http://www.customs.gov.au/webdata/resources/files/audits1.pdf>; KPMG, *Malaysia: Customs Audits on the Rise*, ASIA-PACIFIC TRADE & CUSTOMS NEWS, Jan.–Feb. 2012, at 1, available at <http://www.kpmg.com/cn/en/IssuesAndInsights/ArticlesPublications/Documents/Asia-Pacific-Trade-Customs-News-O-201201-01.pdf>; DIRECTORATE GEN. OF AUDIT CUSTOMS & CENT. EXCISE, NEW DELHI, ANNUAL REPORT: 2008–2009 2 (2010), available at [http://www.dgauditces.gov.in/WriteReadData/3\\_Annual%20Report%202008-09.pdf](http://www.dgauditces.gov.in/WriteReadData/3_Annual%20Report%202008-09.pdf); *Post Clearance Audit*, PAPUA NEW GUINEA CUSTOMS, [http://www.customs.gov.pg/05\\_commercial\\_trade\\_and\\_compliance/92\\_post\\_clearance\\_audit.php](http://www.customs.gov.pg/05_commercial_trade_and_compliance/92_post_clearance_audit.php) (last visited Apr. 29, 2012) (each discussing customs audits in their respective countries).

119. FATF TBML REPORT, *supra* note 26, at 2–8.

120. Negotiating Group on Trade Facilitation, *Draft Consolidated Negotiating Text: Revision*, TN/TF/W/165/Rev.2 (Apr. 30, 2010), available at [http://trade.ec.europa.eu/doclib/docs/2010/june/tradoc\\_146247.pdf](http://trade.ec.europa.eu/doclib/docs/2010/june/tradoc_146247.pdf).

investigate details of a customs declaration after customs releases the goods.<sup>121</sup> In the United States, the authority to conduct audits and impose liability for taxes, duties, and fees is found in 19 U.S.C. 1509.<sup>122</sup>

The Korean system for customs audits could serve as a good TBML customs audit model. Of particular significance is the fact that this system should be attractive for countries that do not have many resources to provide for customs investigations,<sup>123</sup> and it is already highly effective at targeting tax evasion through the trade system.<sup>124</sup> For example, Post Audit Teams allegedly brought in about \$480 million in additional revenues in 2004 from detection of tax evasion and other false import declarations.<sup>125</sup> The system boasts the additional benefit of accelerating customs clearance, which was the initial central purpose behind instituting this program<sup>126</sup> and is similar to the goal of many other customs programs of facilitating legitimate trade movement.<sup>127</sup>

The Korean audit system conducts both pre-audits before goods enter the country (at the point of declaration of goods) and post-audits (conducted after goods are released).<sup>128</sup> Officials select declaration for pre-audit based on numerous criteria including duty or tax exempt goods, goods declared by a delinquent taxpayer, goods with a fluctuating international price, or goods declared by a less compliant importer.<sup>129</sup> Post-audit, performed by regional customs authority, is determined based on a company's classification as an honest importer, quasi-honest importer, importer under general surveillance, and importer under special surveillance.<sup>130</sup> The Korean system divides post-audit into three categories: First, an immediate "case by case" audit within a short amount of time after clearance and based on risk factors and review of customs clearance documents.<sup>131</sup> These auditors determine if proper import duties and taxes were paid on the goods.<sup>132</sup> Second, a planned audit based on goods with a high risk of tax evasion, which is performed by an audit officer at companies themselves.<sup>133</sup> Upon a finding of serious irregularities, the auditor refers

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121. Council Regulation 2913/92, art. 78(2), 1992 O.J. (L 301) (EEC), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992R2913:en:NOT>; Council Regulation 450/2008, art. 27, 2008 O.J. (L 145) (EC), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32008R0450:en:NOT>.

122. U.S. CUSTOMS & BORDER PROT. OFFICE OF STRATEGIC TRADE, REGULATORY AUDIT DIV., FOCUSED ASSESSMENT PROGRAM PRE-ASSESSMENT SURVEY AUDIT PROGRAM 3 (2003), available at [http://www.cbp.gov/linkhandler/cgov/trade/trade\\_programs/audits/focused\\_assessment/fap\\_documents/exh2c.ctt/exh2c.pdf](http://www.cbp.gov/linkhandler/cgov/trade/trade_programs/audits/focused_assessment/fap_documents/exh2c.ctt/exh2c.pdf).

123. See Negotiating Group on Trade Facilitation, *Communication from Korea*, para. 13, TN/TF/W/55 (July 22, 2005) ("Furthermore, based on KCS' experience, it is noted that the Post-Clearance Audit system is one of the effective means to facilitate clearance procedure that does not require significant investment in IT infrastructure or additional manpower.").

124. *Id.* paras. 12, 14.

125. *Id.* para. 12.

126. *Id.* para. 14.

127. See, e.g., U.S. CBP STRATEGY, *supra* note 118, at 14 ("CBP's trade vision is to develop a swift, safe, and secure system by which legitimate imports enter the United States.").

128. KOREA CUSTOMS AND TARIFF, *supra* note 113, at 26.

129. *Id.*

130. *Id.* at 25.

131. *Id.* at 27.

132. *Id.*

133. *Id.*

the company or transaction for further investigation.<sup>134</sup> Third, a comprehensive audit based on a company's trade volume and credibility, determined by information analysis on company risk factors.<sup>135</sup> After the audits, "the companies are classified into different groups based on credibility and law compliance."<sup>136</sup> The comprehensive audit is a self-assessment audit by selected companies to relieve some of the pressure of future audits and help the customs clearance process run more efficiently.<sup>137</sup>

*B. Adapting the Customs Audit into a Risk-Based Customs Audit to Target Trade-Based Money Laundering Through Customs Misrepresentation*

A Risk-Based Customs Audit, which would be a completely new approach to the problem, could be very effective for targeting TBML. Countries could keep a similar customs audit structure and incorporate risk-based analysis. First, countries would conduct a pre-audit before goods arrive using a risk assessment of TBML factors to evaluate declarations and target suspicious transactions for further inspection upon arrival. Next, TBML specialists or customs agents trained in TBML would inspect cargo and examine customs documentation from pre-identified high-risk transactions. This would be followed by a post-audit after goods have been released, looking at the customs documentation in more detail, reserving inspection on arrival for only very high-risk predetermined transactions (e.g., identified by a name or a particular good that has been identified to be used frequently in money laundering activities). Finally, a self-audit could be made available to help identify legitimate businesses or traders not engaged in money laundering.<sup>138</sup> An incentive for companies to engage in a self-audit is that if customs officials trust these companies, the companies' transactions will be more likely to move through the customs process quicker as identified compliant traders.

Under the current Korean customs audit system, risk factors focus on tax evasion.<sup>139</sup> Once TBML is incorporated into the customs audit, risk factors should also be tailored to money laundering. An effective risk-based approach can manage effective risk by using various categories. The commonly used FATF risk categories are "geographic risk; customer risk; and product/service risk."<sup>140</sup> Countries posing a

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134. KOREA CUSTOMS AND TARIFF, *supra* note 113, at 27.

135. *Id.* at 28.

136. *Id.* at 28.

137. *Communication from Korea*, *supra* note 123, at 2.

138. The United States also has a very similar system for targeting other types of crimes such as counterfeiting and evasion of duties. See U.S. CBP STRATEGY, *supra* note 118, at 6-11 (describing the U.S. customs inspection process).

139. See generally, OFFICE OF INSPECTOR GEN., DEP'T OF HOMELAND SEC., CUSTOMS AND BORDER PROTECTION'S OFFICE OF REGULATORY AUDIT, OIG-12-117 (2012), available at [http://www.oig.dhs.gov/assets/Mgmt/2012/OIG\\_12-117\\_Sep12.pdf](http://www.oig.dhs.gov/assets/Mgmt/2012/OIG_12-117_Sep12.pdf) (noting that the audit system is in place to ensure compliance with duties and taxes).

140. FINANCIAL ACTION TASK FORCE, GUIDANCE ON THE RISK-BASED APPROACH TO COMBATING MONEY LAUNDERING AND TERRORIST FINANCING: HIGH LEVEL PRINCIPLES AND PROCEDURES para. 3.3 (2007), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/High%20Level%20Principles%20and%20Procedures.pdf> [hereinafter FATF GUIDANCE ON THE RISK-BASED APPROACH].

geographic risk may include those subject to U.N. sanctions, those lacking in effective AML/CFT laws, those suspected of providing funding to terrorist organizations, and those identified as having a high level of criminal activity.<sup>141</sup> Other TBML risk factors could include names and addresses used in previous money laundering activities as well as specific goods (e.g., hard-to-value goods) or industries that are more commonly abused by money launderers. Additionally, the current customs audit in Korea seems to be targeted mostly at companies; however, customs audits targeting TBML should evaluate both individual as well as company transactions.

The Risk-Based Customs Audit is an attractive alternative for countries that do not have very many financial resources available to allocate to combating TBML. It enables countries to combine resources to target both tax evasion and TBML. Combining resources in this manner to target both crimes makes sense because TBML often results in tax evasion even if it is not the money launderer's principal aim.<sup>142</sup> The current customs audit system (using Korea as a model) will need to be modified and adjusted to include TBML risk factors and specialists that are trained to target TBML. Assuming a country already has a customs audit in place, everyone engaged in these audits should be trained and given guidance on how to target TBML as well as specific protocols and steps for incorporating TBML into the current customs audit system. For countries that do not have a customs audit currently in place, agents should be trained in targeting both tax evasion and TBML from the inception of a Risk-Based Customs Audit initiative.

The customs audit system lends itself well to incorporating TBML because many customs audit systems are already risk-based.<sup>143</sup> A risk-based approach is important to AML efforts because it allows resources to be allocated efficiently and effectively in order to give the most significant risks the utmost attention.<sup>144</sup> The FATF previously recognized this as an option to discharging AML initiatives mainly relating to financial institutions,<sup>145</sup> but a risk-based approach is arguably even more important for effectively combating TBML as trade grows in volume, value, and complexity.<sup>146</sup> As an example, in the United States alone in fiscal year 2007, there were "nearly \$2 trillion in imports combined with over \$1 trillion in exports," and an increase in the value of goods by sixty-five percent from fiscal year 2001 to 2007.<sup>147</sup> Therefore, even in highly developed countries, a risk-based approach to combat TBML is not only encouraged, it is necessary. Additionally, an effective risk-based approach should incorporate information about past compliance as well as up to date information on new trends.<sup>148</sup> The *U.S. Customs and Border Protection Trade Strategy Report 2009–2013* emphasizes that risk management of the customs

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141. *Id.* para. 3.5.

142. AIC TBML REPORT, *supra* note 81, at viii.

143. See U.S. CBP STRATEGY, *supra* note 118, at 12 ("In the face of increasing volume, CBP must assess the risk of incoming cargo to efficiently and effectively set the level and environment for inspection and review. CBP must enhance risk assessment tools and models to better integrate new data, trade information, and enforcement action results. This will improve overall targeting efficiency and ensuing effectiveness of enforcement actions.").

144. FATF GUIDANCE ON THE RISK-BASED APPROACH, *supra* note 140, para. 1.7.

145. *Id.*

146. U.S. CBP STRATEGY, *supra* note 118, at 6.

147. *Id.*

148. See *id.* at 17 (listing strategies to "maintain comprehensive and responsive risk profiles").

inspection process is crucial due to the high volume of trade and limited resources; because “the vast majority of imports are compliant,” it is important to allow compliant transactions to move through the customs process quickly, while utilizing resources in the most efficient way possible.<sup>149</sup> This is consistent with the *FATF Best Practices* emphasis of the importance of guaranteeing that legitimate trade activities are not inhibited or interrupted.<sup>150</sup>

Another reason that the customs audit lends itself well to targeting TBML is that World Trade Organization (WTO) members with a customs audit in place already have a valuation method for detecting customs fraud that is based on the *World Trade Organization General Agreement on Tariffs and Trade*.<sup>151</sup> The main purpose of the WTO valuation is to ensure that import duty rates are administered uniformly and are not arbitrary.<sup>152</sup> For the valuation, most countries use a transactional valuation, which is “the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8 [of the Agreement on Implementation of Article VII of GATT].”<sup>153</sup> If the transactional valuation fails, there is a hierarchy of other valuation methods as alternatives.<sup>154</sup> One of the most crucial difficulties in targeting TBML through customs misrepresentation is valuing the goods. Although there may be some problems with using the WTO valuation methods, for example with hard-to-value goods, at least it is an option for countries to use to begin targeting TBML through the customs audit process.

Although there are many benefits to the Risk-Based Customs Audit approach, including effective and efficient allocation of resources and flexibility in adapting to new threats and trends, there are also challenges to this approach. First, a risk-based approach is challenging because it requires specialized knowledge and expertise to define and identify risks effectively.<sup>155</sup> Although one advantage of this approach is that it will allow countries to target TBML on their own without sharing information between different countries, countries would benefit from sharing information between competent authorities *within* their own boundaries.<sup>156</sup> The approach will be most effective if other sectors, such as the financial sector, cooperate with trade

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149. *Id.* at 16.

150. *See supra* Part II.A. (discussing how the Delston & Walls approach is at conflict with the *FATF Best Practices* goal of not hindering legitimate trade).

151. *See* General Agreement on Tariffs and Trade 1994, art. VII, para. 2(a), 15 Apr. 1994, 1867 U.N.T.S. 187, available at [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/gatt1994\\_04\\_e.htm#article7](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_04_e.htm#article7) (“The value for customs purposes of imported merchandise should be based on the actual value of the imported merchandise on which duty is assessed, or of like merchandise, and should not be based on the value of merchandise of national origin or on arbitrary or fictitious values.”).

152. *See* Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (Customs Valuation Agreement), General Introductory Commentary, 1868 U.N.T.S. 279, available at [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/cusval\\_01\\_e.htm#article1](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/cusval_01_e.htm#article1) (“[r]ecognizing the need for a fair, uniform and neutral system for the valuation of goods for customs purposes that precludes the use of arbitrary or fictitious customs values . . .”).

153. *Id.* art. 1.

154. *Id.* arts. 2–6; *see also* KOREA CUSTOMS AND TARIFF, *supra* note 113, at 23 (describing the Korean method of customs valuation in accordance with the WTO agreement on customs valuation).

155. FATF GUIDANCE ON THE RISK-BASED APPROACH, *supra* note 140, para. 1.20.

156. *See id.* (stating that a risk-based approach “will always benefit from information sharing by competent authorities”).

authorities to assist in identifying high-risk factors. It will also be important for enforcement agencies to cooperate with customs audit officials so that once suspicious transactions are identified as likely TBML transactions, enforcement officials can take action against the money launderers.

Second, the risk-based approach will require customs auditors and inspectors to make judgments based on determination of risk, which officials may not be comfortable with at first.<sup>157</sup> Officials may over- or underestimate risk resulting in less efficient detection; however, many professions require some judgment determinations, and these officials are likely to improve with experience. Making over- or underestimates of risk is better than making no determination at all. Countries should acknowledge that it may take a couple of years to realize return on the initial investment of resources for combating TBML until officials are more familiar with the protocols and what approaches work best.

A statistical analysis of a country's trade data could help mitigate problems associated with risk determinations in the customs audits. Professor John S. Zdanowicz at Florida International University has suggested this type of analysis by utilizing a special data mining methodology to detect discrepancies in trade pricing.<sup>158</sup> Professor Zdanowicz used trade import and export data produced in the U.S. Merchandise Trade Database and pricing norms for suspicious transactions from the U.S. Internal Revenue Service tax code as part of a statistical analysis to determine what goods from different countries were being over- and undervalued.<sup>159</sup> The numbers from the statistical analysis can be used to create country-based and product-based risk indexes.<sup>160</sup> These indexes could be used to aid the Risk-Based Customs Audit at both the pre- and post-audit stages. If a country has the resources to allocate to develop such a program, it would be helpful in identifying trade price discrepancies. In December 2011, the United States started allowing U.S. Customs and Border Protection as well as private auditors, subject to certain restrictions, to start using this type of statistical sampling method to detect trade discrepancies for duties and fines, but not for TBML.<sup>161</sup> It will be interesting to see how well this method works in practice. Although this type of statistical analysis could be helpful for determining risk, it would not be feasible for countries with very limited resources. It would be most helpful as a tool for more developed countries that want to use the Risk-Based Customs Audit approach instead of an approach like the TTUs in the United States that rely heavily on sharing information between

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157. *Id.* para. 1.21.

158. John S. Zdanowicz, *Detecting Money Laundering and Terrorist Financing via Data Mining*, 47 COMM. OF THE ACM 53, 54 (2004), available at <http://www2.econ.uu.nl/users/unger/papers/Zdanowicz%202.pdf>.

159. John S. Zdanowicz, *Trade-based Money Laundering and Terrorist Financing*, 5 FLA. INT'L REV. L. & ECON. 856, 863–64 (2009). Professor Zdanowicz's process is described as follows: "Every import record was evaluated and compared to the country-specific import upper quartile price to determine if it was overvalued. The dollar amount of overvaluation for every import transaction was determined. Similarly, every export record was evaluated and compared to the country specific export lower quartile price to determine if it was undervalued. The dollar amount of undervaluation for every export transaction was determined. The dollar amounts of all undervalued export transactions and all overvalued import transactions for every commodity, for every country were aggregated." Zdanowicz, *supra* note 158.

160. *Id.* at 870.

161. Luis Abad, *New U.S. Customs Audit Rules and Proposed Transfer Price Adjustment Rules Ring in the New Year for U.S. Importers*, What's News In Tax (KPMG), Jan. 12, 2012, at 1, available at <http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/jan-13-2012-tp-customs.pdf>.

countries. Countries that attempt to develop this type of statistical risk-based determination for customs audits should keep in mind that it will work for over- and under-invoicing, but may not detect hard-to-value goods used by money launderers.

Finally, the last criticism of the Risk-Based Customs Audit as a solution to TBML through customs misrepresentation revolves around who benefits from the current non-system and the incentives for various countries to participate in a new system. There are many factors including historic, cultural, and political considerations that weigh against an accepted common system among various countries.<sup>162</sup> The political will and economic circumstances are so variable that it is problematic to have a widely accepted solution that fits all of the various conditions for these countries. However, this variability is also a strength of the Risk-Based Customs Audit. The Risk-Based Customs Audit can be used at different levels to fit a country's needs and resources. Additionally, it gives countries an option to implement a system that is more effective than the current Australian education and awareness approach, while not focusing on a need for sharing information and cooperation between countries like the U.S. approach does. There are unique situations including bribery, corruption, and political and economic alliances, which negatively impact an agreement among all affected entities. Although these could still be problems within individual countries, there is more likely to be agreement within one country than between many dissimilar countries.

## CONCLUSION

TBML is a serious and significant problem that threatens the stability of countries' financial institutions and the safety of individuals and countries from the perilous activities of terrorist organizations and criminal groups that are increasingly resorting to misuse of the trade system in order to finance and disguise their illicit activities. It took from the time the FATF was established in 1989 until the aftermath of the September 11 attacks on the United States in 2001 for countries to begin seriously implementing mechanisms and regulations to effectively target money laundering and terrorist financing in the financial sectors.<sup>163</sup> It would be unfortunate if it took another tragic event, like Iran selling a nuclear weapon to terrorists, for countries and institutions to start getting serious about combating TBML.

Therefore, it is imperative that countries start taking effective action to target TBML. The Risk-Based Customs Audit is a viable alternative for countries that is more effective than the limited Australian approach suggested by the *FATF Best*

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162. See FATF GUIDANCE ON THE RISK-BASED APPROACH, *supra* note 140, paras. 2.22–2.29 (describing factors for forming national risk assessments to tailor different risk-based approaches for individual countries).

163. For example, the NCCT list was started in 2000 and the Mutual Evaluation reports were resumed in 2003 after a four-year absence. FATF ANNUAL REVIEW OF NCCT, *supra* note 70, at 2; FINANCIAL ACTION TASK FORCE, FINANCIAL ACTION TASK FORCE ON MONEY LAUNDERING: ANNUAL REPORT 2003–2004 9 (2004), available at <http://www.fatf-gafi.org/media/fatf/documents/reports/2003%202004%20ENG.pdf>.

*Practices*, but it does not demand as many resources and start-up costs as the current U.S. approach. The Risk-Based Customs Audit provides an effective and efficient option for countries to protect themselves against TBML without having to share privileged customs data or confidential trade strategy and policies with other countries.