

OUTLINING GOOD PRACTICE IN SUPPLY CHAIN CONTROLS FOR TOBACCO PRODUCTS



1. Purpose of this Toolkit

ITIC toolkits are designed to provide guidance for officials in tax and customs authorities on good practices that can help reduce illegal trade in products subject to excise taxation. “Know Your Supplier/Know Your Customer” policies and practices have been found to be useful components of effective supply chain controls. Revenue control would benefit if these policies and practices were to be adopted by all those involved in the tobacco products supply chain from suppliers of ingredients, machinery and components for manufacturing through to customers, including retailers. Similar policies and practices should be expected to apply in other trade sectors involved in the production and distribution of products subject to excise taxation and attractive to smugglers and fraudsters.

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2. Extent and Nature of Illegal Trade in Tobacco Products

The value of the global legal tobacco market was estimated at USD 744.2 billion in 2014, with cigarettes accounting for 91% of all tobacco products.¹ According to the World Health Organization (WHO), one in every ten cigarettes and many other tobacco products consumed in the world in 2014 were illegal.² The illegal trade in tobacco products is based on high profits for criminals and fraudsters combined with low risk of detection or penalty in comparison to trafficking in drugs, arms or people. While illicit markets vary from country to country, factors influencing the illegal trade include price of the legal product (including often a high proportion of tax), availability of legal products and illegal products, disposable income, law enforcement efforts, and the extent of good governance.

Excisable goods such as tobacco products (including cigarettes, fine-cut tobacco, etc.) and alcohol, as well as other items that attract high Customs duty or tax rates, are more vulnerable to smuggling due to the high profits that criminals can generate by selling goods without paying the high duties and taxes. Routes travelled can be complex, with Free Trade Zones (FTZs) often involved. Individuals, companies and criminal organizations exploit lax controls in FTZs and have manufactured and exported shipments illegally, misdeclaring them to disguise their origin and nature.

The shipping industry plays an important role in the movement of containers by focusing on the best routes to connect one port to the other and delivering their cargo to the final customer in the most effective way. About 90% of global trade is conducted using containers, of which more than 500 million are shipped annually, passing through sea ports around the world.³

¹Illicit Trade: Converging Criminal Networks, A Brief Overview of Illicit Trade in Tobacco Products p. 125, OECD 2015, Dr. Sharon Melzer and Chris Martin

²World Health Organization, 2015 see <http://www.who.int/mediacentre/factsheets/fs339/en/>

³Source: <https://www.unodc.org/ropan/en/BorderControl/container-control/ccp.html>

This massive quantity of containers provides opportunities for criminal organizations. The cost of moving illicit goods from their origin to their destination can be insignificant when compared to the gains that can be made through their sale in illegitimate channels. With shipping costs not a concern, the main objective of criminals when moving their illegal products is to avoid detection. Thus, shipments of illicit goods take elongated routes, transiting or transshipping in multiple ports and FTZs around the world.

For more information on good practice controls for Free Trade Zones, see ITIC's *Toolkit to Reduce the Use of Free Trade Zones for Illicit Trade in Tobacco Products*.

Illegal tobacco products can be:

- **Contraband** – genuine tobacco products produced for lawful distribution in their market of intended destination but illegally diverted into a different market.
- **Counterfeit** – tobacco products manufactured without the permission of the trademark rights holder.
- **“Cheap” or “Illicit whites”** – cigarettes usually produced legally in one jurisdiction and smuggled into another market where they have limited or no legal distribution.
- **Undeclared Domestic Products** – tobacco products manufactured and distributed in the same country but not declared to the domestic tax authorities and therefore non-tax paid.

This toolkit focuses on steps that all those involved in the tobacco products supply chain -- from suppliers of manufacturing components to customers such as wholesalers, whatever their size -- should be expected to take to secure the supply chain for legal products.

³Source: <https://www.unodc.org/ropan/en/BorderControl/container-control/ccp.html>

3. Supply Chain Controls – “Know Your Supplier”/”Know Your Customer” Policies and Practices

An effective means of reducing significantly the scope for diversion of genuine tobacco products from the legitimate supply chain is the use of “Know Your Supplier/ Know Your Customer” policies and practices. While such policies and practices should be part of the registration/approval or licensing requirements for manufacturers, bonded warehouse keepers and transporters, additional regulation may be necessary to ensure that these policies and practices are required from others in the supply chain.

It is important to note that “Know Your Supplier/Know Your Customer” policies and practices may have little impact on manufacturers of “cheap” or “illicit” whites, as these are usually legal entities producing legal products in the country of production.

Suppliers may be defined, for the purpose of this toolkit, as those from whom goods or services are bought. Suppliers include: (1) Producers of cigarette making and packing equipment; (2) Producers of garniture tapes; (3) Raw tobacco suppliers; (4) Acetate tow producers; (5) Producers of cigarette paper; (6) Producers of packaging materials; and, (7) Logistics service providers such as transport and warehouse operators and including any provider of services involved in the distribution of the finished products.

Customers may be defined as those to whom products are sold directly (wholesalers/retailers/distributors and third-party manufacturers).

Due diligence controls on suppliers and customers are designed to ensure that a tobacco producer does business only with responsible firms and individuals. These controls should include, at a minimum:

For Suppliers:

- Analysis of all new and existing suppliers to ensure they are legitimate businesses and meet business integrity standards that include a requirement to cooperate with any illicit trade investigation.
- Ongoing monitoring of suppliers including background financial stability and sanction checks on owners, beneficial owners, executives (e.g., executive officers, managing directors, managing partners), directors (e.g., board members) registered with the corporate registry office and managers.
- Raising awareness of the need to implement and enforce similar procedures within the suppliers' own supply chains.
- Suppliers are expected to put in place through their policies and/or commit in their contracts to:
 - Not disclose or supply any materials, equipment or spare parts designed with the tobacco producer's trademarks or specifications to any third party;
 - Destroy any materials, equipment or spare parts returned to the supplier by the tobacco producer and any such materials, equipment or spare parts that the supplier wishes to discard.
 - Carry out due diligence checks on all orders for non-branded materials, equipment or spare parts, sufficient to determine whether such materials are intended to be used in the manufacture of counterfeit products of the tobacco producer.
 - Before approving any customer for the supply of materials, equipment, or spare parts for the production of tobacco products, carry out due diligence checks to satisfy the supplier that the customer is (a) an existing legal entity that complies with all applicable laws and regulations, including, but not limited to, anti-bribery and anti-corruption law, economic sanctions and export controls, intellectual property and anti-smuggling laws, marketing and labor laws, anti-money laundering laws, and environment health and safety law, (b) a reputable enterprise engaged in authorized manufacture of tobacco products. These checks may include, but are not limited to, site visits, receipt of operation specifications, financial credit reports, and public record checks for illegal activity related to counterfeit cigarette production.

- o Where the supplier's customer is an agent, the supplier shall carry out due diligence checks to ensure that the agent is reputable and encourage the agent to carry out "Know Your Customer" checks in relation to the agent's customers.
- o The supplier shall carry out and encourage its agents to carry out "Know Your Customer" checks on existing customers for materials, equipment or spare parts at least annually, and more frequently in the event of any change in control of the customer's business.
- o Where the supplier's or agent's customer is an authorized manufacturer of tobacco products, the supplier shall use best efforts to make sufficient enquiries to satisfy itself that the type and capacity of the equipment ordered or the type of spare parts ordered are in keeping with the nature and scale of the customer's legitimate tobacco products manufacturing business.
- o The supplier and its agents shall decline to accept any order for equipment or spare parts from any individual or entity known to be or to have been involved in the manufacture, distribution or sale of illegal tobacco products.
- o The supplier and its agents shall not supply any equipment or spare parts to any prospective new customer unless the "Know Your Customer" checks have been completed satisfactorily and the supplier has satisfied itself that the materials, equipment or spare parts will not be used to produce illegal tobacco products.
- o Where the supplier's or its agent's customer is an authorized manufacturer of tobacco products, the supplier and its agents shall use their best efforts to ensure that the materials, equipment or spare parts are actually delivered to their customer's facilities and not diverted to any other destination.
- o Suppliers shall agree to not accept payment for materials, equipment or spare parts from any person or entity other than the customer invoiced for the goods or its verified associate.
- o Suppliers and their agents shall agree to not accept cash payments from customers.

For Customers:

- Before approving new significant volume customers, the company should obtain sufficient information about the customer and its business to satisfy themselves that it is:
 - An existing legal entity that complies with all applicable laws and regulations, including, but not limited to, anti-bribery and anti-corruption law, economic sanctions and export controls, intellectual property and anti-smuggling laws, marketing and labor laws, anti-money laundering laws, and environment health and safety law
 - A reputable enterprise engaged in legitimate business, including availability of a license to sell tobacco products if applicable and required by local laws and regulations
 - Creditworthy
- All such information should be documented and checks repeated at regular intervals, including in the event of relevant changes in the customer's business activities or changes in ownership, beneficial owners, executives (e.g. executive officers, managing directors or managing partners), or directors (e.g. board of directors) registered with the corporate registry office. The frequency and extent of due diligence and/or background checks will vary according to factors such as the nature, extent and history of the relationship, the level of purchases and the geographic areas in which the customer trades. If there are any suspicious circumstances or inconsistencies in information, additional due diligence checks should be undertaken.
- The supply chain control expectations should be made clear to all new significant volume customers in the terms of formal written agreements. These should also specify acceptable forms of payment.
- Manufacturers and their customers are expected to put in place through their policies and/or should have in their sales contracts to customers such commitments as:

- The customers agree to distribute, transport and/or resell the cigarettes produced by the given manufacture in full compliance with all applicable laws and regulations.
- The customers agree to take no action directly or indirectly to alter, remove, or deface any identification markings or any other distinctive packaging elements of the cigarettes produced by the manufacturer.
- The customers agree to take no action to promote or facilitate the resale of the cigarettes, produced by the manufacturer, by its subsequent purchasers in violation of any fiscal, labeling, trade, or other laws.
- The customers agree not to resell the cigarettes produced by the manufacturer to any person or entity whom it knows or has reason to believe to be engaged in any illegal trade in cigarettes.
- The customers agree not to purchase, distribute and/or sell any cigarettes that it knows, or with exercise of due care would reasonably suspect, to be counterfeits of the cigarettes or to be genuine cigarettes in a packaging that does not comply with the requirements for the intended market of retail sale, and further agrees to notify the manufacturer promptly of any offer it receives to purchase such counterfeit or genuine cigarettes.
- The customers agree to make reasonable efforts to cooperate with the manufacturer and relevant government authorities for the purposes of investigating cigarette smuggling and/or the laundering of proceeds arising from the illegal trade in cigarettes.
- Manufacturers shall have the right to terminate their contract with a customer if the customer is in breach of these control measures.
- All appropriate records for significant volume customers should be maintained including:
 - A customer approval form detailing the products the customer is authorized to purchase and the market of intended destination (to be signed by a designated operating company officer);

- A policy letter sent periodically to the customer to make clear and remind customers of the supply chain control expectations and raise awareness of the need to implement and enforce procedures within their own supply chains;
 - Due diligence checks (e.g., company search report, details of owners and principal officers, bank references and other creditworthiness checks); and
 - Any enquiries about product diversion from and responses to government agencies regarding the customer or its business.
- Company policy should state that product sales to customers are to be commensurate with what the parties reasonably believe to be the legitimate demand of the market of intended destination.
 - Affiliates of significant volume customers should not be regarded as approved unless they have applied for significant volume customer status separately and been subject to due diligence checks.
 - Employees should maintain a high degree of awareness of customer's business practices so that any signs of questionable conduct are identified and followed up appropriately. Any indication of possible violations should be reported to the relevant officers of the company to determine appropriate action. Appropriate actions should include:
 - Close monitoring of the customer's activities;
 - Suspension or severing of the business relationship; and
 - Reporting the customer to the appropriate government/regulatory authorities if there has been illegal activity.

4. Good Company Practice in Applying “Know Your Supplier”/ “Know Your Customer” Programs

- “Whistle blower” protection: The company should implement a procedure for reporting violations of the “Know Your Supplier”/“Know Your Customer” policy and preserving confidentiality of such information as may be requested by the informant.
- All employees of the company should be made aware that any employee who contravenes the company’s compliance policy will be subject to appropriate disciplinary action.
- Employees of the company should be provided with an explanation of and/or training in the company’s compliance policies including the requirements of “Know Your Supplier” and “Know Your Customer”.

5. Other Compliance Mechanisms

Other indications of good compliance include:

- Existence of a compliance strategy, code of conduct or other policy statement within the company;
- An internal integrity policy covering conduct of all employees;
- Authorized Economic Operator⁴ status; and,
- Compliance with tax and other legislation.

⁴Authorized Economic Operator is an accreditation granted to businesses that satisfy strict customs criteria to demonstrate consistent quality, compliance and trustworthiness in the international supply chain.

6. More Information

- [*The Global Illicit Trade in Tobacco: A Threat to National Security*](#), US Department of State INL report (2015)
- [*The Illicit Trade in Tobacco Products and How to Tackle It \(Second Edition\)*](#), ITIC (2013)
- [*Interpol Legal Handbook on Countering Illicit Trade in Tobacco Products*](#)
- [*Roles and Responsibilities of Intermediaries: Fighting Counterfeiting and Piracy in the Supply Chain*](#), BASCAP (March 2015)
- [*Converging Criminal Networks \(see Tobacco Chapter\)*](#), OECD
- [*Trade in Counterfeit and Pirated Goods – Mapping the Economic Impact*](#), OECD
- EC Agreement and “EC Compliance Protocols”
 - https://ec.europa.eu/anti-fraud/investigations/eu-revenue/cigarette_smuggling_en
- Declaration of Intent To Preventing the Maritime Transportation of Counterfeit Goods (signed by a number of global shipping companies, logistics firms, anti-counterfeiting organizations, and multinational brand owners) (Brussels, November 2016)
 - [*International Chamber of Commerce*](#)
 - [*Maritime Logistics Professional*](#)