THE SOUTH AFRICAN ANTI-MONEY LAUNDERING REGULATORY FRAMEWORK RELEVANT TO POLITICALLY EXPOSED PERSONS

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Submitted in partial fulfilment of the requirements for the degree

MPhil in Fraud Risk Management

In the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

Department of Auditing

At the

UNIVERSITY OF PRETORIA

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April 2013

ACKNOWLEDGEMENTS

All the glory be to God my Father, who gives me wisdom.

To my husband Berto, my sons Dawid and Timo and my sister, Marietjie van As, I cannot thank you enough for your support and all the sacrifices you have made.

To my study leader Danie du Plessis, thank you for your guidance and patience.

ABSTRACT

Politically exposed persons have become a specific risk factor in money laundering. The Financial Action Task Force has formulated clear and specific requirements for dealing with these individuals. Internationally, various jurisdictions such as the United Kingdom and the European Union have adopted effective legislation encompassing the 2003 Financial Action Task Force Recommendations. In South Africa the requirement to apply appropriate, risk based procedures to politically exposed persons has been limited to banks.

The aim of this research study was to identify whether the South African anti-money laundering regulatory framework, adequately addresses managing the risks of politically exposed persons. The regulatory frameworks of the United Kingdom and the European Union, as well as the requirements of the Financial Action Task Force, were used to determine whether best practice is followed in South Africa with regard to politically exposed persons. The process of how money is laundered has been examined as well as the methods that corrupt politically exposed persons use in order to launder money.

The study has shown that politically exposed persons are not regulated in South Africa in accordance with the Financial Action Task Force Recommendations issued in 2003, while the South African Anti-Money Laundering Regulatory Framework does not adequately address the risk posed by corrupt, politically exposed persons. Both international best practice and the recommendations of the World Bank were considered in terms of the way in which to address the risks posed by these persons effectively.

Key words: anti-money laundering, corruption, customer due diligence, European Union, Financial Action Task Force (FATF), Financial Intelligence Centre Act (FICA), money laundering, risk based approach, politically exposed person (PEP), South Africa, United Kingdom

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GLOSSARY OF TERMS

Accountable institution

The term “accountable institutions” refers to any of the institutions as listed in Schedule 1 of the Financial Intelligence Centre Act (No. 38 of 2001), as amended by the Financial Intelligence Centre Amendment Act (No. 11 of 2008). These institutions include, among others, attorneys, trust companies, estate agents, banks, businesses carried on in respect of gambling licences, dealers in foreign exchange, investment advisors, businesses lending money against security of securities and members of stock exchanges (FICA, 2001:50).

Anti-money laundering

Frameworks and efforts, including legislation, enforcement and other means for preventing, detecting and prosecuting money laundering (FATF, 2013b:5).

Basel Committee on Banking Supervision

In 1974, the central bank governors of the Group of 10 countries formed the Basel Committee on Banking Supervision. The central banks represent their individual countries and are, by the relevant authority of those countries, responsible for the prudential supervision of the banking systems. The committee has no force of law or supervisory authority. However, its purpose is to devise supervisory standards and guidelines and to issue best practices statements.(World Bank, 2006:111–113). The countries currently represented on the committee include the United States, the United Kingdom, Germany, Canada, Brazil, China, Russia, Japan, Korea, Switzerland, Singapore and South Africa. (Bank for International Settlements.2013)

Combating the Financing of Terrorism

Comprehensive frameworks and measures implemented to combat the financing of terrorism (FATF, 2012a:7).

Customer due diligence/ Know Your Customer

Customer due diligence includes the process in terms of which a customer is identified and the customer's identity verified (Cox, 2011:21). In this research study the terms "customer due diligence" and "know your customer" will be used interchangeably.

Designated non-financial businesses and professions

The term "designated non-financial businesses and professions" refers to casinos, real estate agents and dealers in precious metals and precious stones. It also refers to professionals working as lawyers and notaries, as well as to other independent legal professionals. Trust and company service providers are also included when any of the following services are rendered to third parties: acting as a formation agent of legal persons, acting as a director or company secretary of a company or as a partner in a partnership. The term also includes instances in which a registered office, accommodation, and a business or administrative address is provided for a company. This, in turn, would include rendering such services for any other legal person. Acting as a trustee for an express trust is also included, as well as acting as a nominee shareholder on behalf of another person (FATF, 2012a:113).

Eastern and Southern African Anti-Money Laundering Group

The Eastern and Southern African Anti-Money Laundering Group is a Financial Action Task Force-style regional body that has at its sole objective anti-money laundering and counter-terrorism financing objectives (World Bank, 2006: IV-2, 3).

Enhanced due diligence

In respect of customer identification and verification, enhanced due diligence refers to instances in which the situation in question represents an increased level of money laundering or terrorist financing risk (Cox, 2011; 52).

European Union

The European Union is a political and economic conglomerate of 27 European countries. It includes most of the European continent (European Union.2012a)

Financial Action Task Force

The Financial Action Task Force was formed at the G7 summit (United States of America, United Kingdom, Japan, Italy, France, Germany and Canada) in Paris in 1989 with the purpose of formulating anti-money laundering policies and procedures, on both a national and international scale, and then assisting in the implementation of these policies and procedures (Turner, 2011:20).

Financial Action Task Force Recommendations

The Financial Action Task Force has made 40 recommendations as international best practice for anti-money laundering. These Recommendations are revised periodically and also include nine special recommendations on the financing of terrorism (Chaikin, 2009:17). The recommendations were revised in 2012 after the previous revision which had taken place in 2003 (FATF, 2012a:7). Throughout this paper, reference was made primarily to the Financial Action Task Force Recommendations of 2003. It was assumed that, although the Recommendations were revised in 2012, countries have not yet had the opportunity to adapt their anti-money laundering regulatory frameworks in line with these later recommendations.

Financial Action Task Force Style Regional Body

The Regional Groups of the Financial Action Task Force on money laundering are referred to as Financial Action Task Force Style Regional Bodies. These bodies are mandated to ensure that anti-money laundering and counter financing of terrorism measures are implemented in their respective regions. There are currently five Financial Action Task Force Style Regional Bodies, namely, Asia/Pacific Group on Money Laundering, the Caribbean Financial Action Task Force, Council of Europe – MONEYVAL, Eastern and Southern

Africa Anti-Money Laundering Group and the Financial Action Task Force on Money Laundering in South America (World Bank,2006: IV-1-IV3).

Financial Intelligence Centre Act (No. 38 of 2001) and (No. 11 of 2008)

The Financial Intelligence Centre Act (No. 38 of 2001), as amended in 2008, was promulgated with the aim of creating the Financial Intelligence Centre and the Anti-Money Laundering Advisory Council. The Financial Intelligence Centre Act (No. 38 of 2001) and (No. 11 of 2008), together with the Prevention of Organised Crime Act (No. 121 of 1998)) and the Protection of Constitutional Democracy against Terrorist and Related Activities Act (Act No. 33 of 2004), works with a unified purpose against both money laundering and the financing of terrorism (FIC, 2012:6).

Financial Intelligence Centre

The South African Financial Intelligence Centre is South Africa's legislative body of which the primary purpose is to introduce ways of combating money laundering and the financing of terrorism. It also generates financial intelligence as required by international standards and requests (FIC, 2012:6).

Financial institutions

The term "financial institution" refers to a natural or legal person who, as a business conducts, among other things, deposit taking, money lending, money transfer services, issuing and managing means of payment, portfolio management and money and currency changing on behalf of a client. It would also include the placement of life and investment-related insurance and the investment, administration and management of funds on behalf of other persons (FATF, 2012a:115, 116).

Financial Services Authority

The Financial Services Authority is the regulator of financial services in the United Kingdom, with its statutory objectives being to create market confidence,

ensure financial stability, protect consumer rights and reduce financial crime (Cox, 2011:63).

Gatekeepers

In essence, the term “gatekeepers” refers to individuals who protect the gates to the financial system. All natural and legal entities, as well as money launderers, have to pass through these gates if they are to be successful (FATF, 2011:19). The term includes attorneys, accountants and persons who assist in the creation of legal entities (FATF, 2011:7).

G7

The Group of Seven is made up of the world’s seven leading industrial countries, namely, the United States of America, the United Kingdom, Japan, Italy, France, Germany and Canada (Leong, 2007:153).

Her Majesty’s Revenue and Customs

Her Majesty’s Revenue and Customs administers the tax system in the United Kingdom utilising various commissioners and is regarded as the country’s tax authority (HMRC, 2012:2). In terms of the Money Laundering Regulations, Her Majesty’s Revenue and Customs has been appointed as the supervisory body in respect of managers, directors, employees, proprietors and nominated officers of trust or company service providers (HMRC, 2010:1).

International Cooperation Review Group

This Financial Action Task Force body has, since 2007, been tasked with examining high-risk jurisdictions and then advising on detailed actions to be taken to limit any money laundering and/or terrorist financing arising from these jurisdictions (Financial Action Task Force . 2012e)

International Monetary Fund

The purpose of the International Monetary Fund is to advance international monetary stability. This is achieved by, among other things, providing loans to

countries which would allow such countries to address any instabilities in their balance of payments that would otherwise have a detrimental effect on national or international prosperity. The International Monetary Fund is also mandated to assist in promoting international monetary cooperation and also in promoting the development of international trade (World Bank, 2006:x-1, x-2).

International Organization of Securities Commissions

This organisation is regarded as the benchmark for securities markets. It regulates more that 90% of the international securities markets while, as part of its mandate, it also has supervisory functions as regards preventing money laundering (World Bank, 2009:32).

Know Your Client/Customer Due Diligence

Know Your Client/customer due diligence involves risk management procedures with regard to customer due diligence and customer identification (World Bank, 2006:II-8). In this research study the terms “customer due diligence” and “Know Your Customer” will be used interchangeably.

Money laundering

Money laundering may be described as obtaining ownership and/or owning or using property, while being aware that the property is the proceeds of crime. It also includes any action in terms of which such property is converted or transferred, whilst being aware that such property is the proceeds of crime, in order to hide the criminal origin of such property. In addition, money laundering includes any action by a person that would constitute any assistance to commit the aforementioned crimes (Goredema & Madzima, 2009:15, 16).

MONEYVAL

The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, otherwise known as MONEYVAL, was formed in 1997 by the Committee of Ministers of the Council of Europe. MONEYVAL has been mandated to undertake evaluation reports of the

member states of the European Union, which are not Financial Action Task Force members, in order to ensure that the anti-money laundering measures of these member states are in line with the Financial Action Task Force Recommendations (Financial Action Task Force. 2012f.)

Politically exposed persons

The term “politically exposed persons” refers to individuals who are or who have been entrusted with prominent public functions, for example heads of state or government, senior politicians, senior government, judicial or military officials senior executives of state owned corporations and important political party officials.

A distinction is made between foreign and domestic politically exposed persons. Foreign politically exposed persons are those individuals who occupy prominent public functions in a foreign country. Persons who have been entrusted with prominent public functions domestically are regarded as domestic politically exposed persons. This term also includes persons who have been entrusted with a prominent function by an international organisation and may include directors, deputy directors and members of a board. Politically exposed persons do not include middle ranking or more junior individuals in foreign countries. (FATF, 2012a:118, 119). It also refers to their immediate family members and or persons known to be close associates of these politically exposed persons (European Union, 2005: L309/30).

Regulatory framework

A regulatory framework is a system consisting of regulations and how these regulations are to be enforced within a specific designated area. A regulatory framework is typically created by a government with the purpose of regulating selected activities (QFinance. 2013).

Reporting institution

Reporting institutions are referred to in Schedule 3 of the Financial Intelligence Centre Act and include car dealers and dealers in Kruger Rand (FICA, 2001:52).

Terrorist Financing

The financing of terrorists, their acts and organisations (FATF, 2012a:121).

The Prevention of Organised Crime Act (No. 121 of 1998)

This Act was promulgated in 1998 and brought the crime of money laundering into South African legislation and stipulates the penalties for a money laundering conviction (FIC, 2012:6)

The Protection of Constitutional Democracy against Terrorist and Related Activities (Act No. 33 of 2004)

This Act was promulgated with the purpose of introducing procedures for dealing with the financing of acts of terrorism (FIC, 2012:6).

Transparency International

Transparency International refers to the international organisation that has at its aim assisting in the fight against corruption. The organisation produces the annual Global Corruption Report and the TI Corruption Perceptions Index (Cox, 2011:176).

Third EU Directive

On 26 October 2005, the European Parliament issued the Third Directive 2005/60/EC for the purpose of preventing the use of the financial system for the purposes of money laundering and terrorist financing. Directive 2006/70/EC was issued on 1 August 2006 and provided guidelines on the implementation of Directive 2005/60/EC. It provided for the definition of a politically exposed person and stipulated for easier customer due diligence and certain exemptions

for financial activities which are exercised occasionally or to a limited extent only (Greenberg et al, 2010:xi).

United Nations Convention Against Corruption

The United Nations Convention Against Corruption was adopted in 2003 and came into effect in 2005. It is regarded as one of the most crucial international efforts against corruption and money laundering. At its core is the promotion, facilitation and backing of international cooperation and technical assistance in the prevention and combating of corruption. It also provides for the asset recovery of assets received through corruption. It has been ratified by 160 countries (FATF, 2012b:24).

United Kingdom

Four principal countries make up the United Kingdom, namely, England, Wales, Scotland and Ireland. England and Wales function as one jurisdiction and, together with Northern Ireland, form a common law jurisdiction. On the other hand, Scotland employs a mixed system which includes civil and common law principles. These four countries form a political union and act as a constitutional monarchy. A prime minister who has been elected on a democratic basis exercises executive power on behalf of Her Majesty, Queen Elizabeth II, together with cabinet ministers who head up the various state departments (FATF, 2007b:4).

United Nations Office on Drugs and Crime

The United Nations Office on Drugs and Crime is an international organisation committed to the fight against drugs and international crime. It also acts as the primary entity at the United Nations. The United Nations provides legal and technical assistance in the war against terrorism (UNODC, 2010:13).

Wolfsberg Group

The Wolfsberg Group was formed in 2000, with the aim of drafting anti-money laundering guidelines for private banking. It consists of a group of 11 financial

institutions, which have developed industry standards and policies for both anti-money laundering and combating the finance of terrorism. Its foremost role is to fight corruption and to support international anti-money laundering efforts. The group is led by the private sector and, with its principles, guidelines and statements, it wields considerable influence and its principles are regarded by both government bodies and industry regulators as international best practice (Cox, 2011:76).

LIST OF ABBREVIATIONS

AI	Accountable institution
AML	Anti-money laundering
CDD	Customer due diligence
CFT	Combating the financing of terrorism
DNFBP	Designated non-financial businesses and professions
EDD	Enhanced due diligence
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
EU	European Union
FATF	Financial Action Task Force
FATF 40 + 9	Financial Action Task Force Forty Recommendations plus Nine Special Recommendations, 2003
FATFR	Financial Action Task Force Recommendations, 2012
FSRB	Financial Action Task Force Style Regional Body
FI	Financial institution/s
FIC	Financial Intelligence Centre
FICA	Financial Intelligence Centre Act (No 38 of 2001) as amended and read with the Financial Intelligence Centre Amendment Act (No 11 of 2008) (South Africa)
FIU	Financial Intelligence Unit
FSA	Financial Services Authority of the United Kingdom
ICRG	International Cooperation Review Group
IMF	International Monetary Fund

IOSCO	International Organization of Securities Commissions
JMLSG	Joint Money Laundering Steering Group
KYC	Know your client
ML	Money laundering
MLR	The United Kingdom Money laundering regulations
PEP	Politically exposed person
POCA	Prevention of Organised Crime Act (No. 121 of 1998) (South Africa)
POCDATARA	Protection of Constitutional Democracy against Terrorist and Related Activities Act (No. 33 of 2004) (South Africa)
RBA	Risk-based approach
SA	South Africa
Third AMLD	Third Anti-Money Laundering Directive (European Union Directive 2005/60/EC)
TI	Transparency International
UNCAC	United Nations Convention Against Corruption
UK	United Kingdom
UNODC	United Nations Office on Drugs and Crime
WGTYP	Working Group on Typologies
US	United States of America

THE SOUTH AFRICAN ANTI-MONEY LAUNDERING REGULATORY FRAMEWORK RELEVANT TO POLITICALLY EXPOSED PERSONS

CHAPTER 1: INTRODUCTION

1.1 THE PRECEPTS OF MONEY LAUNDERING

Internationally, the issue of money laundering (ML) is receiving increased attention while posing a significant challenge to most countries with regard to the prevention, detection and prosecution thereof. The complexity of the issue has also increased as techniques for laundering the proceeds of crime have become more sophisticated. However, irrespective of the increased complexity of ML techniques, ML is, in essence, not a complicated concept and may be described as a practice in terms of which earnings from a criminal activity are disguised in order to conceal their illegal origins (World Bank, 2006: I-1).

It would appear that the term was derived from Al Capone's strategy of using, among other things, laundromats to hide the profits from bootlegged alcohol during the prohibition era (Chaikin, 2009:14). Essentially, money laundering involves a three-stage process during which illegal funds are received and introduced into the financial system; these funds are layered and then integrated back into the financial system (Cox, 2011:4). South African legislation has defined money laundering in the Prevention of Organised Crime Act 1998 (POCA) as the carrying out of any act which may result in, or has the potential to result in, the concealing of the nature of the proceeds of crime, enabling a person to avoid prosecution or in the diminishing of such proceeds (FATF and ESAAMLG, 2009:30).

The Eastern and Southern African Anti-Money Laundering Group (ESAAMLG) defines ML as dealing with illegal gains in order to hide their unlawful origin so as to legitimise the illicit gains from crime. The concept of ML also includes any person who may assist in the commission of the aforementioned offences (Goredema, 2009:15, 16). The United Nations (UN) recognised the following four negative consequences of ML, namely, it has a negative effect on business, it has adverse consequences for a country's development, it has a detrimental effect on the economy of the country and it is damaging to the rule of law. ML enables criminals to enjoy their illicit gains. It may also cause serious damage to the reputations of those financial institutions (FI) which deal with criminals who wish to launder

their illicit gains. ML may also hamper the ability of such financial institutions to establish relationships with legitimate businesses. In addition, it may have other negative effects on business, including increasing the prudential risk to bank security; contaminating legal financial transactions and increasing the volatility of international capital flows and exchange rates. ML also undermines a free and competitive business market (Bachus, 2004:838, 839).

The international drug trade placed money laundering on the policy agenda in the 1980s as a problem that was necessitating an international coordinated response. In 1988, the UN Vienna Convention against Illicit Trade in Narcotic Drugs and Psychotropic Substances, represented the first international agreement designed to counter ML. Although the Vienna Convention focused on the drug trade as a facet of ML, it also created many of the main elements of the current anti-money laundering (AML) regime, the first of which was to define ML as a criminal offence (Chaikin, 2009:16).

International AML efforts developed rapidly in the early 1990s and new and specialised international AML organisations were established. The most significant of these organisations was the Financial Action Task Force (FATF) which was formed in 1989 as a result of the G7 Summit held in Paris in 1989. The FATF‘s main purpose was to examine existing ML techniques and developments, both national and international, and to provide recommendations for improving AML measures (Cox, 2011:16). The FATF has subsequently developed its 40 Recommendations as regards the fight against ML. As a response to the September 11 2001 terrorist attacks in America; an additional nine Special Recommendations were introduced (Cox, 2011:17).

The FATF Recommendations indicated that the criminal justice system was not capable of combating ML and that ML measures had to be initiated through the regulation of private financial intermediaries. In 1996 its recommendations were revised and the focus shifted from drug money to illegal gains from all types of crime. In terms of the “Know Your Customer” (KYC) procedure financial institutions (FI) were required to identify with whom they were doing business, while they were also obliged to report suspicious transactions (Chaikin, 2009:18). In 2001, as a result of the attacks on New York and Washington, the FATF’s mandate was expanded to include measures to counter the funding of terrorist acts and terrorist organisations. This resulted in the creation of the Eight (later Nine) Special Recommendations on Terrorist Financing. In 2003 the FATF Recommendations were

revised for a second time with the latest revision of these recommendations being published in February 2012 (FATF, 2012a:7).

Member countries of the FATF are expected to adopt all the recommendations as well as the monitoring mechanisms such as mutual evaluation reports which have been implemented to address compliance with the recommendations. After an FATF mutual evaluation, the specific country's standard of compliance and weaknesses in terms of anti-money laundering and combating the financing of terrorism (AML/CFT) are included in a mutual evaluation report. The latest South African evaluation report was published in 2009 (FATF & ESAAMLG, 2009:6). Monitoring applies to member countries only, although the FATF also monitors compliance by way of the International Cooperation Review Group (ICRG), which publicly identifies high risk and/or non-cooperative countries (FATF, 2012b:20). The FATF's mandate also extends to the issuing of typology reports which contain new research on developments in ML and terrorist financing methods (World Bank, 2006: IX: 1:10).

1.2 INTERNATIONAL ANTI-MONEY LAUNDERING REGULATORY FRAMEWORKS

The Financial Action Task Force

In 1989, the FATF was created at the G7 Summit in Paris with the following mandate, namely, to formulate AML policies and procedures that may be used on both a national and an international level and to assist in their implementation. Its mandate also extended to efforts to make it more difficult for criminals to commit ML and to create standard principles as regards AML efforts. In 1990, the FATF created its first 40 recommendations which were later reviewed in 1996 (Turner, 2011:20). Its mandate was further extended in 2001 to include combating the financing of terrorism. After the 11 September 2001 attacks on the United States of America (US), an additional Nine Special Recommendations were issued in order to act as a counter measure to the financing of terrorism and terrorist attacks (COX, 2011:17).

The FATF is regarded as a policy-making body with combined inputs from legal, law enforcement and financial experts and with the aim of creating regulatory frameworks for AML/CFT (Worldbank, 2006:III-8). It operates as an independent, inter-governmental body with the aim of protecting the international financial systems from ML, CFT and also the financing and proliferation of weapons of mass destruction. The recommendations issued by the FATF are regarded as the international AML and CFT standard (FATF, 2012a:2).

The 40 Recommendations do not constitute an international convention that binds countries on a legal basis and, instead, countries are offered some leeway as regards implementing the Recommendations in terms of their own regulatory frameworks. However, various international bodies have approved the Financial Action Task Force Recommendations while the largest countries have agreed to abide by the recommendations in their efforts to combat ML/CFT (COX, 2011:17).

The Financial Action Task Force Recommendations (FATFR) focus on novel and evolving ML dangers in order to provide a better understanding of, and reinforce the current duties it provides for. The new FATFR also focus on an enhanced risk-based approach (RBA) to AML/CFT efforts. This RBA will provide countries with the opportunity to be more flexible as regards their own regulatory frameworks, to apply their funds more efficiently and to ensure that risks form the basis of their AML/CFT efforts (FATF 2012a:8).

The Regulatory Framework of the United Kingdom

In the United Kingdom, ML has been criminalised in terms of the Proceeds of Crime Act 2002 (FATF, 2007b:33) while the Counter-Terrorism Act of 2008 criminalises the financing of terrorism (FATF, 2009:17). ML is also further regulated through the Money Laundering Regulations (MLR), which were amended in 2007 to incorporate the European Union's Third Anti - Money Laundering Directive (Third AMLD) (FATF, 2009:5). A risk based approach is used in the UK to control ML and to ensure initial customer due diligence and the ongoing monitoring of clients (OFT: 2009, 17).

The Financial Services Authority (FSA) is the statutory regulator and will commence proceedings as regards contraventions of the MLR (Cox, 2011:68). The Joint Money Laundering Steering Group (JMLSG) represents the majority of financial services provider trade associations in the United Kingdom, and acts as a private corporation. The purpose of the JMLSG is to develop guidelines for the industry as regards compliance with legal and regulatory requirements and also to set the standard for best practice in respect of AML/CFT. Her Majesty's Treasury has formally approved the guidelines provided by the JMLSG (FATF, 2007b:27).

Third European Union Anti-Money Laundering Directive

The European Union has adopted the FATF Recommendations, in the form of various money laundering directives, to ensure united AML legislation throughout Europe. The

Third AMLD was published in 2005 although member states were granted time until 2007 to incorporate this directive in their legislation (Cox, 2011:45).

The Directive was revised to bring it in line with the latest FATF recommendations in order, inter alia, to extend the scope as regards transgressions requiring a risk based approach (RBA) to client identification, and as a joint effort to combat ML in terrorist financing (Mugarura, 2011:181). The Directive obliges all member states to ensure that ML and terrorist financing are outlawed to the maximum extent (Cox, 2011:47).

1.3 THE SOUTH AFRICAN ANTI-MONEY LAUNDERING REGULATORY FRAMEWORK

Section 4 of the Prevention of Organised Crime Act No. 121 of 1998 (POCA) has criminalised ML in South Africa (FATF & ESAAMLG, 2009:30), while terrorist financing has been criminalised in terms of the Protection of Constitutional Democracy against Terrorist and Related Activities Act No. 33 of 2004 (POCDATARA).

The Financial Intelligence Centre Act 2001(No. 38 of 2001) (FICA), which was amended in terms of the Financial Intelligence Centre Amendment Act 2008 (No. 11 of 2008) (FIC Amendment Act), has been adopted in South Africa in order to implement all anti-money laundering/combating the financing of terrorism (AML/CTF) measures. In addition to the FICA Regulations, exemptions have also been published to supplement the AML/CTF measures adopted (FATF & ESAAMLG, 2009:8). The FICA authorises the issue of guidance notes in order to assist entities regulated by the Act in the practical implementation of Act. These guidance notes are provided as general information, should not be construed as legal advice and do not replace FICA or its Regulations (FIC, n.d.:3:2). The Financial Intelligence Centre (FIC) also provides guidance in the form of Public Compliance Communications (PCC). This guidance is authoritative and non-compliance with the guidance provided may result in action being taken to enforce compliance (FIC, 2012b:1).

The Financial Intelligence Unit (FIU) operating in South Africa is known as the FIC and has been mandated to assist law enforcement departments, the South African Revenue Service and intelligence agencies with financial intelligence. The FIC does this by ensuring that certain categories of business, which must comply with the FICA, register with the FIC and by reporting on certain transactions. The information obtained in this manner is then scrutinised to determine trends and to check the flow of funds in the economy (FIC, 2011:2).

The FICA includes control measures that will assist in detecting and investigating ML and CTF. These measures require that client identities be established, records of transactions be preserved and possible suspicious transactions be reported to the FIC (FIC, n.d.:1).

Most of the duties in terms of the FICA fall to entities which are referred to as "accountable institutions". These accountable institutions are listed in Schedule 1 to the FICA and include, among others, attorneys, trust companies, estate agents, banks, businesses carried on in respect of gambling licences, dealers in foreign exchange, investment advisors, businesses lending money against security of securities and members of stock exchanges (FICA, Schedule 1). Schedule 3 of the FICA also contains details of reporting institutions, namely, motor vehicle dealers and dealers in Kruger Rands (FICA, Schedule 3). Section 28 of the Act requires that both accountable and reporting institutions report cash transactions over the amount of R24 999.99 to the FIC (FIC, 2010c:3), while section 29 requires that both accountable and reporting institutions and all other businesses submit reports relating to possible terrorist financing, as well as suspicious ML transactions to the FIC (FATF/ESAAMLG, SA, 2009:9).

1.4 A RISK-BASED APPROACHED TO ANTI-MONEY LAUNDERING

The notion of applying the concept of risk to ML arose as a result of the enhanced focus on the part of regulators and management on operational risk in the 1990s. This enhanced focus was a result of internal systems becoming so complicated that there was a possibility that they may have given rise to undesirable exposure and as a result of increased risk-taking due to deregulation and market volatility (Chaikin, 2009a:21).

The notion of risk was introduced specifically into the FATF 40 + 9, which requires that FI, in their AML regulation, ensure that their application of such AML regulation is proportionate to the risk of ML. This, in turn, implies that more resources be focused on high risk transactions and less on lower risk transactions (Simonova, 2011:346, 347).

The FATF 40 + 9 indicate that countries may, to a certain extent, adopt an RBA to both ML and CTF. The adoption of an RBA enables role players to ensure that the measures they implement in respect of ML and CTF are proportionate to the risks which they pose. Thus, resources may be allocated in such a way that the highest risks receive the most attention. However, implementing an RBA suggests that a risk management process will be devised for dealing with ML and CTF. A risk management process entails identifying risks,

assessing these risks and then formulating policies and procedures designed to manage and mitigate these risks (FATF, 2007a:2). As regards an RBA it is compulsory that certain measures be adopted to address risks. However, there is no prescribed method for the identification and management of these risks and, thus, an RBA is a principle-based and not rule-based approach (Sathye & Islam, 2011:170).

A risk management process includes conducting a risk analysis, which will then determine where the ML and terrorist financing (TF) risks are the greatest. Thus, an FI will have to identify high risk products, services, customers and locations. Risk management policies for AML and CTF include a three-pronged approach, namely, prevention, detection and record keeping. However, risk management procedures should be proportionate to the risks assessed. This would mean that, in certain instances, enhanced customer due diligence would have to be undertaken. Employing an efficient RBA enables FI to use reasonable economic judgements in respect of their customers. Nevertheless, a well-designed RBA would not hinder an FI in establishing new customer relations, but would aid the FI in efficiently managing both the ML and the TF risks (FATF, 2007a:3).

The FATFR comments that the adoption of an RBA is an efficient way in to combat ML and TF (FATF, 2012a:31). The FATFR focuses on new and emerging threats and improves the requirements pertaining to high risk situations. The adoption of such an RBA would then enable countries to apply their resources proportionate to the ML risks posed (FATF, 2012a:8). The FATFR recommends that countries recognise, evaluate and comprehend the ML and TF risks that are specific to the country concerned and that countries apply measures to ensure that these risks are adequately addressed. In other words, countries should adopt an RBA to ensure that the ML and TF risks that have been identified are being addressed in a way that is proportional to the risk that they pose (FATF, 2012a:11).

According to the FATFR, Recommendation 1, adopting an RBA is an “essential foundation” for an AML organisation. The core foundation of the FATFR includes customer identification and verification, as well as familiarity with the type of transaction and its purpose, and then the application of enhanced customer due diligence (EDD), where appropriate. When FI understand ML and TF risks, they will be able to mitigate the risks adequately (FATF, 2012b:5).

The Wolfsberg Group has commented that adopting an RBA is crucial to the effective and efficient war against ML. One of the advantages of the RBA is that it creates a culture in

which efforts are prioritised in accordance with the likelihood of ML and TF occurring (Wolfsberg Group, 2006:7).

Another advantage of an RBA is that, as compared to more rigid methodologies, in terms of which obligations are the same for customers of all risk profiles and budgets are divided equally in a business despite its AML risks, it is assumed that serious attention has been given to all the AML risks faced (Greenberg et al, 2010:24).

In businesses that are conducted in an uncomplicated manner and which offer limited products, with most customers being categorised in a similar way, a basic approach may be followed. However, where business dealings are more intricate, the RBA adopted will be more complex (HMRC, 2010:10). Politically exposed persons (PEPs) may cause serious damage to the reputations of these more complex businesses should ML or TF be detected and, thus, it is essential that businesses focus on products or transactions that may, potentially, carry more risk for the purposes of ML. It should also then be determined whether PEPs have been identified in the list of customers. In such an event, enhanced due diligence (EDD) should be applied to all such PEPs (Cox, 2011:75).

A well-considered RBA has definite advantages in dealing with the risks associated with PEPs and it would enable businesses to determine the risk that PEPs hold on a less prescriptive basis, thus allowing for funds to be directed to the higher risk areas. Such an RBA has been proved to be more efficient than a rule based approach. (Greenberg et al, 2010:24). It has been suggested that regulators and those whom they regulate should not use a “checklist-based” PEP classification, but should rather, when dealing with PEPs, use an RBA that would include considering the jurisdiction and entities from which the PEPs come. FI’s could also define their own risk measures in respect of PEPs by having regard to both the length of time for which persons will be considered to be PEPs as well as to whether domestic PEPs should be scrutinised. The definition of PEPs may also be based on factors such as the seniority of a PEP and close family members or associates of the PEPs, posing a higher risk as relatives of the PEP. (Choo, 2008:373).

The FICA contains limited requirements as regards applying an RBA to the establishment and verification of customers’ identities and, as a result, accountable institutions adopt the approach to customers, irrespective of whether the customer is a high risk customer. Despite the fact that the FIC has issued Guidance Note 1 on applying an RBA, accountable institutions are not obliged to adopt a “one-size-fits-all” method to identifying and verifying the identities of customers. This Guidance Note indicates that an RBA may be followed in

verifying a customer's identity and, thus, should there be a higher risk, the level of verification should be greater and the verification methods more secure (FATF & ESAAMLG, 2009:28).

1.5 THE SIGNIFICANCE OF POLITICALLY EXPOSED PERSONS

The international banking community's involvement in corruption was highlighted during the Durban Declaration in 1999, as certain banks had assisted the corrupt leaders of developing countries to deposit and host monies stolen from their countries. The banking sector was requested to assist in identifying corruption and ML by creating enforceable duties to keep records of financial transactions. Proof was submitted that heads of state, including Marcos of the Philippines, Abacha of Nigeria, Mobutu in Zaire and Duvalier of Haiti, had illegally accumulated massive fortunes during their reigns. It was inconceivable that the stolen funds from these corrupt leaders should be hosted in developed countries when the developing countries had suffered as a result of their losses (Johnson, 2008a:291, 292).

An increasing issue has arisen around the corruption and abuse of public funds by PEPs. High-profile investigations have revealed how significant amounts of illicit wealth have been amassed by PEPs and also that these funds are often hosted in foreign jurisdictions and hidden in trusts, private companies, foundations or in the names of family members or associates of these PEPs (FATF, 2002:12).

It is widely accepted that the term "politically exposed person (PEP)" was conceived during the case against Imelda Marcos (Leppan, 2005:3). Also known as the Steel Butterfly, she was arrested in 2001 on charges of corruption and extortion committed during the presidency of her husband from 1965 to 1986. It was argued that approximately US$684 million had vanished from the Philippine Treasury during her husband's reign. In 2003, the Swiss Courts ordered that those funds that were hosted in Swiss bank accounts be returned to the government of the Philippines. It has been suggested that Imelda Marcos and her husband had defrauded their country of up to US$25 billion (De Klerk, 2007:368).

Sani Abacha ruled as president of Nigeria from 1993 to his death in 1998. The Nigerian Treasury discovered that, during his reign, he and his family had stolen government funds of up to US$4 billion. The methods which he had used to steal and launder his country's funds had included making requests to Treasury for "security needs", to overbilling and to kickback schemes (FATF, 2012b:16).

The demise of Riggs Bank provides a good example of why an FI should deal with PEPs in an efficient and effective way. In 2004, the United States Senate investigated Riggs Bank on the basis that most of Equatorial Guinea's oil revenues were being paid into the bank. It emerged that the dictator of Equatorial Guinea at the time, Mbasago, had withdrawn almost US$35 million of this oil money, without proper reports being submitted to the authorities (De Klerk, 2007:371).

Riggs Bank, in contravention of both the Bank Secrecy Act of 1970 and the USA Patriot Act of 2001, had also assisted the Chilean dictator, Pinochet, to create bank accounts under false names and to hide assets in various trust and shell companies (Chaikin, 2009:80).

Gatekeepers have been identified as a common element in the creation of sophisticated ML schemes with their profession enabling them to create legal entities in terms of which it is possible to launder money. Case studies have identified how gatekeepers created corporate vehicles, opened bank accounts, bought real estate and transferred proceeds to avoid AML measures (FATF, 2010a:45).

The president of Haiti, Duvalier, used lawyers to hold accounts on behalf of his family with assets that had been stolen from the Haitian government being hidden in these accounts. A former president of Zambia, Chiluba, also used lawyers to hide funds stolen from the Zambian government (FATF, 2011:20).

PEPs have been identified as one of the main classes of high-risk customers for ML purposes. This high risk posed by PEPs is mainly as a result of their stations of influence and they are, potentially, able to access substantial government funds while they are often conversant with budgets, public companies and contracts over which they are able to exert control. It is, therefore, possible for corrupt PEPs either to award tenders in return for kickbacks or to create entities into which government funds may be deposited (FATF, 2011:9).

FI and designated non-financial businesses and professions (DNFBPs) are constantly dealing with customers of various risk levels and it is therefore essential that both these FI and DNFBPS adopt risk management policies in terms of which customers are classified according to the risk they pose. This classification will enable high risk customers to be identified and EDD may then be applied to them (MENAFATF, 2008:2).

In Recommendation 12 the FATFR indicates that PEPs constitute one of the categories of clients to whom EDD measures should be applied (FATFR, 2012a:16).

In 2001, the Basel Committee on Banking Supervision issued a paper, “Customer Due Diligence for Banks”, in which banking supervisors identified PEPs as a distinct category of client that has the potential to expose banks to significant reputational and legal risks. The paper acknowledges the need to provide guidance on the risks posed by PEPs, indicating that “[i]t is clearly undesirable, unethical and incompatible with the fit and proper conduct of banking operations to accept or maintain a business relationship if the bank knows or must assume that the funds derive from corruption or misuse of public assets” (Basel, 2001:10, 11).

The FATF 40 + 9 followed suit in 2003, with the Basel Paper, with its Recommendations in which preventative measures were presented regarding the identification of higher risk customers and the monitoring of their transactions. These measures were contained in Recommendation 6 with the customer due diligence requirements being contained in Recommendation 5 (Greenberg et al, 2011:5).

Article 52(1) and (2) of the 2003 United Nations Convention Against Corruption (UNCAC) indicates that enhanced scrutiny of the accounts held by PEPs was required in order to prevent and detect the transfer of the proceeds of crime (UNODC, 2004:42).

PEPs are defined in the FATFR recommendation as follows: “Foreign PEPs are individuals who are or have been entrusted with prominent public functions by a foreign country, for example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials.” Domestic PEPs are now also included in the definition with persons who have been entrusted with prominent public functions in the domestic context being regarded as domestic PEPs (FATF, 2012a:118). It also refers to their immediate family members and or persons known to be close associates of these politically exposed persons (European Union, 2005: L309/30).

However, there is no universally agreed-on definition of PEPs (Choo, 2008:372). The Third AMLD defines PEPs as natural persons who are or have been entrusted with prominent public functions, and the immediate family members or persons known to be close associates of such persons.

FI face particular challenges in dealing with PEPs. Normal customer due diligence (CDD) measures will not suffice for these individuals as financial transactions and business relationships with them pose increased ML risk and, therefore, EDD is required. In order to

mitigate the ML risk of dealing with PEPs, the Third AMLD and FATF Recommendations contain specific provisions for establishing business relationships with PEPS (Choo, 2008:375).

A low level of international compliance is evident in the most recent FATF and FATF Style Regional Body (FSRB) mutual evaluation reports. In the evaluation of 124 jurisdictions it was found that 61% were non-compliant and 23% were partially compliant with the FATF 40 + 9 on PEPs. Three jurisdictions only were found to be fully compliant. This finding appeared to be similar to the FATF and FSRB reports, with compliance in the FATF jurisdictions being lower (Greenberg et al, 2010:7). It appears that the low levels of compliance may be attributed to the absence of enforceable legal or regulatory frameworks. A review of 82 mutual evaluation reports by the FATF and FSRB revealed that 40% of the jurisdictions did not have enforceable legislation or regulations governing PEPs in place (Greenberg et al, 2010:13).

It is essential that efforts in respect of PEPs be increased for a variety of reasons, including the devastating effect that corruption may have on the economy of a country, with one corrupt PEP being able to exert a devastating effect on a country. PEPs may also pose a serious reputational risk and this indicates why normal CDDs are not sufficient for PEPs (Greenberg et al, 2010:16).

1.6 ANTI-MONEY LAUNDERING REGULATORY FRAMEWORKS RELEVANT TO POLITICALLY EXPOSED PERSONS

THE FINANCIAL ACTION TASK FORCE

In 2001, the FATF investigated ML risks in private banking and the commensurate risk posed by senior public officials to these FI. The risk that was identified involved the use of international private banks by these senior public officials and the fact that the origin of their deposits could be illegal. The US Senate conducted hearings and drew up a report on private banking that indicated how US multinational banks were involved in ML by hosting the illegal gains of corrupt political leaders from Nigeria, Mexico, Pakistan and Gabon. These hearings and the subsequent report had a significant impact of the FATF's view of PEPs (Chaikin, 2009:85).

In the FATF 40 + 9, PEPS have been defined as

> … individuals who are or have been entrusted with prominent public functions in a foreign country, for example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves (FATF, 2003b: 17).

The FATF Typologies Report issued in 2004 explained the risks posed by PEPS. It identified that the illegal funds that PEPs may want to launder can include "bribes, illegal kickbacks, and other directly corruption-related proceeds but also may be embezzlement or outright theft of state assets or funds from political parties and unions as well as tax fraud". In addition, their activities may also include drug trafficking and organised crime. A link was also made between the fact that, in countries with high levels of corruption, the possibility of corrupt PEPs increases, although corrupt PEPs may be found anywhere (FATF, 2004a:19).

In the FATFR, PEPS are dealt with in Recommendation 12, previously Recommendation 6, under the heading of preventive measures for specific customers and activities (FATF, 2012a:4). In its Recommendation 12, the FATFR requires that EDD be applied to foreign PEPs and that such EDD include using a risk management system in order to be able to identify whether or not a customer is a PEP, obtain senior management approval for establishing a business relationship with such PEP, adequately determine the source of wealth and funds of the PEP and ensure the ongoing monitoring of the association with the PEP. The same requirements are also applicable both to domestic PEPs and to persons carrying out prominent functions in international organisations. In other words, where required, EDD should also be applied to these individuals (FATF, 2012a:16).

UNITED KINGDOM

The 2007 Money Laundering Regulations define a PEP is an individual who is or has been, in the previous year, entrusted with a prominent public function by a non-UK country, the European Community or an international body. The definition also includes the immediate family members and close associates of such a person (FSA, 2011a:16). Regulation 14 of these Regulations stipulates that firms have to apply EDD to an RBA with regard to dealings or occasional transactions with PEPs. Such EDD should include senior

management approval for establishing such a business relationship, identifying the source of wealth and/or funds and conducting enhanced, ongoing monitoring of the dealings with the PEP (HMRC, 2010:21).

EUROPEAN UNION

The European Union's Third AMLD provides European Union members states with a definitive legal framework for dealing with PEPs. The Third AMLD uses the FATF's definition of a PEP as well as its requirements. However, it requires that EDD be applied to foreign PEPs only. In its implementation measures it provides illustrations of categories of PEPs, while also providing for a one-year period after leaving office, at which point such a person will no longer be considered a PEP (Greenberg et al, 2010:19).

Thus, the Third AMLD defines a PEP as a person who is or has been entrusted with a prominent public function, as well as his/her immediate family and close associates. Where PEPs live in the member states of third countries, firms are obliged to use an RBA in order to identify a PEP, obtain senior manager approval for dealing with such a customer, determine the source of wealth and/or funds of the PEP and ensure that enhanced, ongoing monitoring takes place in all dealing with such a PEP (Cox, 2011:53–54).

SOUTH AFRICA

ML has been criminalised by way of legislation in South Africa in the form of POCA. The FICA stipulates the control measures for the detection and investigation of ML (De Koker 2006, 717). These control measures are based on the three basic principles of ML detection and investigation, namely, that intermediaries in the financial system must know with whom they are conducting business; that a paper trail of transactions should be kept and that possible ML transactions should be reported to the FIC. The FICA also created the FIC and, in terms of section 4(c) of the Act, the centre may give guidance on matters concerning compliance with FICA (FIC, 2005: 3:1, 2).

In 2005, the FIC issued Guidance Note 3, which applied specifically to banks. The purpose of this Guidance Note 3 is to assist these institutions with the practical application of the client identification and client verification requirements contained in the FICA. Section 25 of the Guidance Note contains a definition of a PEP, as well as indicating the measures to be put in place when dealing with PEPs. A PEP is described as an individual who is or has been entrusted with a prominent public function in a particular country. The Guidance Note

proceeds to indicate that the definition applies to both domestic and foreign PEPs. The Guidance Note also states that the Wolfsberg Group provides an indication of best banking practice with regard to PEPs (De Klerk, 2007:381).

Banks are required to carry out a proper due diligence on both PEPs and persons acting on their behalf. In accordance with the FATF 40 + 9, PEPs are high risk clients and banks are obliged to take specific actions with regard to them (De Koker, 2004:726). Accordingly, in addition to conducting a CDD, banks should also adopt specific risk management procedures to determine whether a customer, potential customer or beneficial owner is a PEP. Banks are also required, when dealing with PEPs, to obtain senior management approval for establishing such a relationship, establish the source of funds and conduct an ongoing monitoring of the relationship with the PEP. In addition, banks are required to address PEPs in accordance with both their risk frameworks and their group money laundering control policy (FIC, 2005:26, 27).

In the FATF/ESAAMLG'S 2009 mutual evaluation report of South Africa on the issue of compliance with Recommendation 6 of FATF 40 + 9 (deals with PEPs, now Recommendation 12 of the 2012 FATFR, which also deals with PEPs), the report indicated that there is no enforceable obligation on the part of accountable institutions to identify PEPs. It acknowledged that Guidance Note 3, which had been issued, contained provisions on PEPs, but noted that it applies to banks and the other institutions as mentioned above only (FATF/ESAAMLG, SA, and 2009:103).

As regards Recommendation 6 of the FATF 40 + 9 (which deals with PEPs), the report indicated South Africa's status as not compliant, because there was no enforceable obligation on the part of FI either to identify PEPs or take such other measures as required by Recommendation 6 (FATF/ESAAMLG, SA, 2009:216).

The action plan recommended in the report in respect of improving AML/CTF in South Africa stated under preventative measures for FI that a primary obligation be introduced for accountable institutions as regards identifying PEPs and applying EDD to such PEP relationships (FATF/ESAAMLG, SA, 2009:226).

1.7 THE PURPOSE OF THE RESEARCH STUDY

1.7.1 Research problem

The issue of PEPs are dealt with in Recommendation 6 of the FATF 40 + 9. In terms of this recommendation FI are advised, in respect of PEPs, to identify whether a customer is a PEP by means of risk management systems, acquire senior management approval for establishing a business relationship with such customers, use reasonable measures to determine the source of their wealth and funds, and to undertake the enhanced monitoring of such a business relationship (FATF, 2004a:5, 6). In the interpretive notes to these recommendations, countries are advised to apply Recommendation 6 to persons who hold prominent public positions in their own countries (FATF, 2003b:22).

Recommendation 12 of the FATFR requires that, in relation to foreign PEPs, FI also apply EDD measures in addition to the usual CDD. FI should also be able to determine whether a customer or beneficial owner is either a domestic PEP, or has a prominent function within an international organisation (FATF, 2012a:16).

The FATF 40 + 9 and FATFR differ as regards the requirements of PEPs. For the purpose of this research study, the South African regulatory framework has been compared to that of the FATF 40 + 9. The implication of this comparison is that, should the research problem, as discussed hereunder, be proved, the gap between the FATFR requirements in respect of PEPs and the requirements contained in the South African regulatory framework would be even wider. This is as a result of the more stringent requirements for PEPs contained in the FATFR; which also now includes head of international organisations and domestic PEPs in its definition of PEPs. The Mutual Evaluation Report on South Africa indicated that there was non-compliance with Recommendation 6 and, thus, the assumption is made that the non-compliance in this area is now even more comprehensive compared with the enhanced requirements for PEPs contained in Recommendation 12 of the FATFR.

PEPs constitute a unique category of client and, as such, have been classified as high risk for the purposes of ML. FI have a duty to identify PEPs as part of their CDD measures and this identification comprises a crucial aspect of the overall AML/CTF policies and procedures of FI. Insufficient CDD procedures may result either in PEPs not being identified at all or that the risk that a certain PEP customer poses is misjudged (Greenberg et al, 2010:14). In the United Kingdom, the MLR requires that, among other things, EDD

measures are always applied where the customer is a PEP (FSA, 2011a: 10, 11). The MLR apply to a wide range of financial sector firms, including banks, entities involved in regulated investment activities, trust and company services providers and lawyers and accountants, where applicable (Cox,2011:68). Not all PEPs are corrupt, but a single corrupt PEP may plunder states assets, exercise undue influence on the awarding of state contracts and use the national and international financial systems to launder the assets which have been acquired illicitly (Greenberg et al, 2010:xiii).

The research study has shown that the international PEP regulations of AML institutions vary between what is required by the FATF 40 + 9, FATFR, the Third European Union Anti-Money Laundering Directive and The United Kingdom legislation. This, in turn, has resulted in the lack of an internationally accepted definition of the term “PEP”.

The research question involved whether the South African AML regulatory framework complies fully with the FATF 40 + 9 on PEPs and whether improved PEP regulation is required for AML/CTF efforts in South Africa. The regulation of PEPs in South Africa has been compared to that of the FATF 40 + 9, the FATFR and other international AML regulatory frameworks, to determine whether international best practices are being followed in South Africa with regard to PEP regulation. The assumption has been made that, if South Africa does not comply with the FATF 40 + 9 in respect of PEPs, this would mean that South Africa’s non-compliance with the PEP regulation will be even greater under the FATFR.

1.7.2 Research objectives

The UNCAC has been endorsed by 141 countries, while in excess of 170 jurisdictions have adopted the FATF 40 + 9 as their AML standard. However, despite this, recent mutual evaluation reports issued by the FATF and FSRBs indicate that more than 80% of these jurisdictions have yet to implement effective measures in this regard. Specifically, as regards the FATF 40 + 9 on PEPs, it was found that 61% of jurisdictions were non-compliant and 23% only were partially compliant (Greenberg et al, 2010:7).

In addition to the lack of a universally accepted definition of PEPs and problems in identifying a PEP as a beneficial owner, the fact that ML schemes are becoming increasingly complex has made the identification of PEPs even more challenging for FI (Greenberg et al, 2010:17).

The main aim of this research study was to analyse and evaluate the adequacy of PEP regulation in the South African AML regulatory framework. Thus, the study aimed to draw a conclusion as to whether PEPs are being regulated sufficiently so as to adequately combat ML in South Africa. The South African AML legislative framework has been compared to that of the United Kingdom and the EU, under the FATF 40 + 9, as a result of the assumption that these regions have well-developed AML regimes, as well as specific regulatory requirements which have been issued in respect of PEPs. For the purposes of this research study, both the EU and the United Kingdom will be used as examples of jurisdictions in which the FATF 40 + 9 is applied efficiently as a result of well-developed AML systems.

The primary research objective has been supported by the investigation of the following secondary objectives:

- to comprehend the concept of money laundering, and its intricate mechanisms
- to identify international, anti-money laundering regulatory frameworks
- to identify the South African AML regulatory framework
- to understand the requirements of following an RBA to the AML requirements relevant to PEPs
- to establish the origins behind the identification, definition and regulation of PEPs
- to identify and compare the current regulatory requirements of the FATF 40 + 9, the EU and the United Kingdom, as well as South Africa‘s legislative requirements as regards the management of PEPs.

1.7.3 Research approach

An analysis has been conducted of what is understood by the term “PEP” and also how PEPs are being regulated internationally. It would be determined whether there is effective PEP regulation on both a South African and an international level in order to combat money laundering effectively.

The FATF 40 + 9 with regard to PEPs, CDD and the EDD requirements were examined, in addition to the FATF 40 + 9 recommendations as regards following an RBA to ML . The regulatory requirements of the United Kingdom and the EU, as under the FATF 40 + 9, with

regard to PEPs were considered, in addition to the requirements of their various regulatory bodies as regards following an RBA to dealing with PEPs.

In addition, the regulation of PEPs in terms of FICA were considered, whether this is efficient in terms of the FATF 40 + 9 and also how this regulation compares to the United Kingdom and EU PEP regulation. Recommendations which have been issued on improved PEP regulation were considered as a possible way in which to improve South African AML measures.

1.7.4 Research study limitations

PEP regulation in SA were compared to that of the FATF 40 + 9, as well as that contained in the EU and United Kingdom frameworks, as under the FATF 40 + 9. There is no internationally accepted definition of PEPs and various jurisdictions have adopted different regulatory frameworks in this respect. This research study was limited to South Africa, the United Kingdom and the EU. The study did not address the financing of terrorism in respect of PEP regulation, because it was assumed that the problem with PEPs is associated more with fraud and corruption than with the financing of terrorism. The study also did not refer to the international and electronic databases in respect of PEPs, nor to the various methodologies used to identify PEPs. In addition, the research study did not include the issue of compliance with the FATFR because the assumption was made that countries have not had the opportunity to implement the requirements contained therein.

1.8 RESEARCH DESIGN

As regards the research design, a content analysis was conducted of literature pertaining to the research topic. Relevant publications were reviewed and compared, based on the United Kingdom and the EU requirements for dealing with PEPs as compared to the South African legislative standard.

The FATF, FSRB, FSA and FIC reports and guidelines were the primary sources of the literature reviewed. However, academic works and articles as well as professional journals also constituted primary sources of the literature that was reviewed. The official websites of the FATF, FSRB, World Bank and FIC can be considered secondary sources of the literature reviewed.

The assumption was made that the United Kingdom and the EU are at the forefront of the AML legislation, which formed the basis of the research design.

1.9 RESEARCH METHODOLOGY

The research took the form of a literature review. The purpose of a literature review is to state a concept, review literature based on the concept and provide a breakdown of what has been reviewed. Conclusions then drawn from the theory reviewed, will form the basis of the literature review (Hofstee, 2006:91).

A literature review can fulfil many functions, including providing a historical framework of the topic in question, providing a summary of the prevailing philosophy and ideas on the research topic, referring to similar research in the field and identifying those areas in relation to the research topic on which more work is needed. In addition, a literature review may also provide evidence of the challenges which the research is attempting to identify, thus confirming their relevance (Ridley, 2012:24).

The literature review conducted on the research topic has been limited to research on ML, with specific reference to PEPs, as well as certain international and national regulatory frameworks for dealing with PEPs.

1.9.1 Advantages and disadvantages of a literature review

The main advantage of a literature review is that academic works published on the research topic can be considered and the most relevant material identified. A literature review will also reveal differing views on the research topic and any paradoxes contained in the material (Leedy & Ormrod, 2010:79).

A literature review can be described as “a systematic and thorough search of all types of published literature in order to identify as many items as possible that are relevant to a particular topic” (Ridley, 2012:24).

The possible disadvantages of a literature review include limitations regarding the sources used, the challenge of correctly reflecting the sources used and also any preconceptions the researcher may have (Hofstee, 2006:121).

The accessibility of electronic information has made the issue of literature reviews more challenging as the amount of information available is enormous and there are many ways in which such information can be retrieved (Ridley, 2012:24).

1.9.2 Method used to conduct the literature search

The method used to conduct the literature search included using key words on the University of Pretoria's online library catalogue. The key words used were *politically exposed persons* relevant to *money laundering, risk-based approach, anti-money laundering and corruption*. The search for the term *politically exposed persons* on Google Scholar led to 142 000 results. However, the search was narrowed down by using the term *politically exposed persons* in conjunction with the term *money laundering.*

The online library provided access to academic books, professional journals and online journals. No specific academic books could be found on PEPs, although a number of books were available on ML and related matters. Various academic articles were identified on the subject of PEPs. Google Scholar was used to identify academic research on ML and PEPs issued since 2000.

The main method applied in the literature search involved using the FATF 40 + 9. The websites of the FATF, FIC, FSA and various other international bodies were also searched for relevant information. Selected information has in addition been obtained of newspaper articles from websites.

No other dissertations on PEPs could be found on the website of the University of Pretoria, although those on money laundering provided a valuable source of related research material.

The research was limited to the United Kingdom, EU and South African legislative frameworks for PEPs. However, in view of the volume of information available internationally on ML and PEPs, particularly from well-developed countries such as Australia and the United States of America, the purpose was not to conduct any research into the AML regimes applicable to these countries.

1.9.3 Constraints of a literature study

A literature review will always be limited to condensing and systematising existing academic work on the research topic. Accordingly, inaccuracies may arise as a result of choosing sources on a discriminatory basis, not consulting all writers in equal measure, incorrectly

interpreting a source and conducting a biased analysis based on the writer's opinion of the topic (Mouton, 2001:80).

In view of the vast amount of information available on AML and PEPs, the literature review was limited to publications from the year 2000 onwards. The number of academic publications on the topic of PEPs in South Africa is extremely limited, however, and thus the study focused on international sources on the topic.

1.10 CHAPTER OUTLINE

An outline of the chapters contained in the study is provided below:

1.10.1 Chapter 1: Introduction

This chapter outlines the purpose of the research study, the methodology followed and the composition of the dissertation.

1.10.2 Chapter 2: The precepts of money laundering

This chapter explains the concept of money laundering, including its origin, various processes involved in money laundering and the problems associated with money laundering.

1.10.3 Chapter 3: International anti-money laundering regulatory frameworks

The regulatory frameworks of the FATF, United Kingdom and EU are discussed with regard to AML/CTF are discussed in this chapter.

1.10.4 Chapter 4: The South African anti-money laundering regulatory framework

The current South African AML/CTF regulatory framework is described in this chapter.

1.10.5 Chapter 5: Risk-based approaches to anti-money laundering

This chapter examines the concept of an RBA and focuses on the FATF report and its recommendations regarding an RBA. The chapter also discusses how an RBA may be applied to managing the risks that PEPs pose.

1.10.6 Chapter 6: The significance of politically exposed persons

The chapter examines the concept of a PEP; the various definitions of the term, the problems associated with PEPs and the different regulatory requirements applicable to PEPs. Recommendations in respect of improved PEP management are made.

1.10.7 Chapter 7: An analysis of anti-money laundering regulatory frameworks relevant to politically exposed persons

The legislative requirements pertaining to PEPs in the FATFR, United Kingdom, EU and South Africa are reviewed in this chapter, together with comments on reports published in this regard.

1.10.8 Chapter 8: Conclusions and recommendations

This chapter presents the conclusions drawn with regard to the literature reviewed. A review of the South African regulatory requirements in respect of PEPs is recommended while future areas of research on the topic are also identified.

CHAPTER 2: THE PRECEPTS OF MONEY LAUNDERING

2.1 THE ORIGINS OF MONEY LAUNDERING

It is widely recognised that ML has its origins in organised crime and the criminal deeds perpetrated by such organised crime groups in the 1930s (Vaithilingam & Nair, 2007:353). The Italian Mafia and other criminal gangs had obtained large sums of cash as a result of their illegal activities which included gambling, prostitution and extortion. In order to make use of these vast amounts of cash, they resorted to buying businesses so that their financial gains would appear to be legal (Turner, 2011:2).

Al Capone, who was infamous for his habit of taking his illegally acquired money and channelling it through launderettes so that it appeared to be income derived from a legitimate source, may be regarded as the source of the term “money laundering” (Unger, Siegel, Ferwerda, De Kruijf, Busuioic, Wokke & Rawlings, 2006:20). Meyer Lansky helped the Mafia to hide their money from scrutiny by the government. On his instructions, cash from the US was transported to Switzerland and then placed on loan to criminal gangs. This process, which is known as the “loan-to-back” principle, conceals the actual timing of the illegal money. A common method of ML evolved from this practice (Turner, 2011: 2, 3).

2.2 DEFINING MONEY LAUNDERING

Various definitions of ML have been identified. For example, money laundering has been described as a process aimed at frustrating the prosecution of crime with the criminal being able to offer an explanation for the assets derived from various criminal activities. ML may include all actions which are concluded for the purpose of hiding or disguising the nature or source of, or claim to, money or property derived from criminal activities (Smit, 2001:1).

In its UNODC Model Law on Money Laundering, Proceeds of Crime and Terrorist Financing, the United Nations Office on Drugs and Crime (UNODC) defines ML as the process whereby a person acquires, possesses or uses property, knowing or having reason to believe that it is derived, directly or indirectly, from acts or omissions which constitute a crime against any law, and for which imprisonment of more than 12 months may be ordered. ML may also include instances in which a person assists someone with the aforementioned. In the 1996 FATF Recommendations, ML was defined as criminal proceeds being processed to disguise their illegal origin. On the other hand, the International Monetary Fund (IMF) defines ML as assets obtained or generated by criminal activity being moved or concealed to obscure their link with crime, while the International

Organization of Securities Commissions (IOSCO) defines ML as a wide range of activities and processes with the purpose of obscuring the source of illegally obtained money in order to create the appearance that it has originated from a legitimate source (Unger et al., 2006:33, 34).

In the POCA, ML is defined as an activity which has, or is likely to have, the result of hiding the nature, source, place or movement of the proceeds of criminal actions, or any interest which a person may have in such gains (POCA, Section 4 & 5).

2.3 METHODS OF LAUNDERING MONEY

The definitive purpose of ML is to create the impression that money gained from an illicit source has been legally obtained. For this reason, ML is used by "transnational" criminals so as to enable them to be able to enjoy their ill-gotten funds. It has been identified that offshore banks and shell companies are preferred by money launderers in hiding the true origin of their funds (Haigner, Schneider & Wakolbinger, 2012:31).

ML has been described by the FATF as comprising the following three stages: illegally acquired money is placed into the financial system, the money is then layered to hide where it came from and, lastly, the money is then integrated into a legitimate economy (Levi, 2002:183). The three stages of ML may take place either in the form of a once-off transaction or in various transactions concluded over a period of time (Rhodes & Palastrand, 2005:9).

2.3.1 Placement

In the first stage off the process the ill-gotten gains are often placed in FI. This allows these funds to enter the financial system. There are various ways in which this can be accomplished, for example, currencies can be exchanged, deposits may be made into banks by splitting up larger amounts into smaller amounts (these deposits may even be made over a period of time and/or into various branches of a bank or into various banks), various forms of financial instruments may be purchased or else the ill-gotten funds may be used to buy insurance policies or securities (World Bank, 2006:I–7). During this stage the cash may also be transported to a foreign FI or else items such as boats, jewellery, and works of art or aircraft may be purchased. However, there are costs and risks associated with whichever method is used; costs and risks that would not have existed had the funds been obtained legally (Turner, 2011:9).

2.3.2 Layering

During the layering stage of ML, various complicated transactions are generated in order to ensure that it is no longer possible to link the ill-gotten gains to their illegitimate source. These transactions will ensure it is not possible to determine either the owner and/or the origin of the funds and that any "audit trail" is erased (Rhodes & Palastrand, 2005:9). During this stage a simple investment may be made into a legitimate instrument, or there may be a series of extremely complicated transactions. Illegal funds may be transferred to various accounts in numerous jurisdictions and by way of an array of companies. There have been instances in which money has been transferred approximately 10 times before being integrated into an FI. Where formal records of purchases are not maintained, there is very little risk that the ML will be detected (Cox, 2011:12).

2.3.3 Integration

During this final stage, the offender will attempt to reintroduce the ill-gotten funds into legal financial markets. This is usually achieved by the criminals buying assets such as property, businesses and financial instruments (World Bank, 2006: I–9). The successful reintegration of these funds into a legitimate financial system will enable the criminals to enjoy the funds as the impression will have been created that the funds were obtained legally. If it is no longer possible to distinguish between the legal and illegally gained funds, the money launderers will be able to have access to them. It is, however, crucial for the criminals, at this stage, to ensure that their use of these funds does not attract any attention to them (Cox, 2011:13). Methods of integration that have been successfully used include employing a front company to loan monies from foreign FI and keeping the illegally gained funds as the loans have been assured by deposits and the FI that facilitated the loan is not at risk (Turner, 2011:10).

2.3.4 Money laundering typologies

The approach adopted by ML offenders will be contingent on how and where the offence was committed, the sophistication of the offending syndicate, the capacity of the offending syndicate to intimidate others to assist them in their crimes, the offender's level of sophistication, his/her access to technology and his/her ability to afford the services of financial specialists to devise and execute ML schemes (Leong, 2007:141). It has been observed that FI are the favoured vehicle used by criminals in ML because of their efficiency and the low cost involved in executing financial transactions (Vaithilingam & Nair,

2007:353). In addition, the rapid evolution of technology has enabled gaps to be identified that may be used for ML. In 2001 the FATF report on ML typologies indicated that online banking and the internet are among the foremost money laundering vehicles (Vaithilingam & Nair, 2007:354).

An ML method known as “Starburst” which is used regularly by money launderers provides an example of the way in which the various layers of ML may be applied in practice. In terms of the “Starburst” method, Illegally gained money is deposited into a bank with a standing instruction to transfer the money in small, random amounts to hundreds of other banks accounts around the world and, thus, into both offshore and onshore financial systems (Haigner et al., 2012:31).

The method of ML employed will always relate to the specific criminal activity and also to the AML frameworks adopted in the region in which the crime is being committed. Drug lords with constant access to smaller amounts of cash would tend to place such money in businesses such as restaurants, which are “cash intensive” operations (Haigner et al., 2012:31).

Various techniques of laundering money have been identified, ranging from making numerous insignificant cash deposits into an FI, with the money then being layered into other FI, to more sophisticated methods which are constantly evolving. It has been observed that ML typologies depend on a country’s overall culture with regard to both AML measures and enforcement as well as to the country’s unique economy and financial environment (World Bank, 2006:I-9, I-10).

During the placement phase a method known as “smurfing and structuring” may be used. This involves avoiding the reporting of cash threshold transactions by breaking up large deposits into smaller deposits (Unger et al., 2006:66).

The FATF has identified ML typologies that are relevant to specific industries and which occur on a regular basis. These include the use of wire transfers that move funds quickly between FI and regions. These wire transfers may be made purposely complex as this obscures the source and purpose of the funds. Trends have also been identified in terms of which, increasingly, legitimate and professional individuals, referred to as gatekeepers, are used to assist money launderers to hide the proceeds of their crimes (FATF, 2004a:1).

Money launderers are often in possession of huge amounts of cash and, thus, they frequently buy casinos in order to be able to explain the amounts of cash held, or they use

the cash to buy chips, which they then convert back into cash. Restaurants and hotels are also useful as regards accounting for large sums of cash held, while luxury items and consumer goods may be purchased in order to be transported across borders for resale purposes. Such items are often bought for cash as this does not arouse any suspicion (Unger et al., 2006:69, 70).

Although ML "through the front door", for example, with FI, is being adequately regulated, ML "through the back door" has been neglected. The main method of ML through the back door takes the form of "abnormal international trade pricing" (Zdanowicz, 2004:53).

2.3.5 South African money laundering typologies

In terms of the ESAAMLG, the following three distinct typologies of ML have been identified within the region, namely, internal ML where the proceeds of crime come from within the specific country, incoming ML where the proceeds of crime committed outside the country are introduced into the country and outgoing ML where the illegally gained funds are exported from the country where the crimes were committed (Goredema, 2003:3).

Despite the fact that specific ML typology reports have not yet been drafted in South Africa, law enforcement agencies have reported that their ML investigations revolve around corruption, fraud, gambling and Nigerian "419" schemes. Ponzi-type schemes and drug trafficking are also high on the agenda of ML investigations (FATF & ESAAMLG, 2009:16).

In 2002, drugs to the value of R2,7 billion were seized in Johannesburg, South Africa. It would appear that approximately 100 drug syndicates are active in South Africa, laundering the proceeds of their crime locally by acquiring vehicles, real estate, or businesses or through shell companies. Acquiring these types of asset makes sense in view of the cash-intensive nature of drug smuggling (Goredema, 2003:4).

Various ML typologies have surfaced in South Africa. During the FIFA 2010 World Cup, the FIC assisted with investigations into accommodation scams aimed at overseas visitors. In addition, a Ponzi scheme and a pyramid scheme were uncovered, a card skimming syndicate was exposed and the FIC assisted with the profiling of cash-in-transit robberies. (FIC, 2011:4, 5).

The FIC has recently started identifying ML crimes according to geographic and other indicators. The crimes of drug trafficking and tax evasion fall within the ambit of crimes identified in terms of these indicators, while they have also specifically assisted law

enforcement by referring issues relating to both rhino poaching syndicates and organised crime syndicates for investigation (FIC, 2012:13).

2.4 THE EXTENT AND EFFECTS OF MONEY LAUNDERING

The International Monetary Fund (IMF) has estimated that ML comprises 2 to 5% of the world's gross domestic product. John Walker was the first analyst who attempted to quantify ML and he estimated that an amount of $2,85 trillion is laundered internationally (Unger et al, 2006:5). Reports from the IMF suggest that ML may involve in the vicinity of $1,5 trillion (Kumar, 2012:113), while it has been estimated that ML may be considered to be the world's third largest industry behind the oil trade and foreign exchange (Leong, 2007:141). The Executive Director of the UNODC, Yury Fedotov, commented on 15 October 2012, during the sixth session of the conference of parties to the United Nations Convention against Transnational Organised Crime, that the cost of transnational, organised crime has been quantified at $870 billion (UNODC, 2012a).

The significance of ML is to be found in the fact that it enables criminals by growing their capacity, it is destructive to FI and it is detrimental to legitimate capital (Levi, 2002:184). In addition, ML is vital as regards the motivation of terrorists, drug traffickers and organised crime rings in enabling them to avoid the authorities detecting the new found wealth which they have acquired as a result of their criminal activities (Kumar, 2012:113).

More than 25 potential effects of ML have been identified, including losses to the victims and gains on the part of the offenders, as well as the misrepresentation of consumption, investments and savings that ML may lead to. ML may also cause an artificial increase in prices, lead to unbalanced competition, cause deviations in the imports and exports of a country and have either a positive or an adverse effect on the growth rate of a country. It may decrease the income of the public sector and also influence the output, income and employment in an economy. The reputation, profits and liquidity of the financial sector may be compromised by ML. In addition, ML may also lead to corruption and an increase in crime, while also undermining political institutions and foreign policy goals and leading to an increase in terrorism (Unger et al., 2006:100,101).

The economic and political stability of a country may be adversely affected when illicitly acquired funds are introduced into financial systems. A country's economy may suffer significantly when ML in the form of tax evasion leads to reduced income for the

government of the country concerned and this, in turn, may lead to reduced expenditure on the development of the country's infrastructure (Kumar, 2012:115).

Research has suggested that effective corporate governance, efficient legal frameworks and advanced capacities for innovation in economies may all contribute to a reduction in ML activities (Vaithilingam Nair, 2007:364)

2.5 MONEY LAUNDERING AND CORRUPTION

> Corruption and money laundering are a related and self-reinforcing phenomenon. Corruption proceeds are disguised and laundered by corrupt officials to be able to spend or invest such proceeds. At the same time, corruption in a country's AML institutions (including financial institutions regulators, Financial Intelligence Units (FIUs), police, prosecutors, and courts) can render an AML regime of a country ineffective (World Bank, 2007:66).

A recent "guesstimate" by the World Bank has indicated that African countries lose up to 25% of their gross national product as a result of corruption. According to the World Bank, corruption is "the single greatest obstacle to reducing poverty" (Sharman & Chaikin, 2009:27).

Research has indicated that ML and corruption are linked, while corruption may be both a predicate offence and also an enabler of ML. Either the financial gains resulting from corruption can be subject to ML or ML can be enabled by the corruption of those entities and individuals which are intended to deter ML (Goredema, 2004:4).

The fact that corrupt public officials have no way of enjoying their stolen funds if they are not able to place, layer and integrate these illicit funds into financial systems, further supports the notion that ML and corruption are closely linked (FATF, 2011:6).

Transparency International has defined corruption as the abuse of powers for private enrichment (Transparency International, 2004:1) while sections 15 to 22 of the UNCAC describe corruption as both the active and passive bribery of public officers, locally and internationally; the diverting or misappropriation of public property by public officials or illegal enrichment of public officials; as well as bribery and misappropriation of funds in private businesses (Sharman & Chaikin, 2009:31).

Corruption can drain countries economically, it may pose a very real threat to the established democracies of countries and also undermine the rule of law, including any

AML frameworks which have been adopted. In addition, corruption has the potential to expose the economy of a country to the possibility of financial abuse, including ML, and this, in turn, may lead to the demise of FI (Mugarura, 2010:276). Private investors are reluctant to invest in economies which are known to harbour corruption and this, in effect, may lead to a decrease in tax income. Corruption also results in inefficient public infrastructure, has a negative effect on the effectiveness of financial systems while also having a far greater effect on the poor than on other members of society. Literacy rates are lower in corrupt countries than other countries, while corruption can also have an adverse effect on mortality rates, as public spending is limited by corruption.

In addition, capital flight is an important effect of corruption, as is evidenced by the guesstimate that, in 2008, $1,26 to $1,44 trillion vanished from the poorer countries. This capital flight, which is linked to corruption, contributes significantly to the increase in illegal financial flows (FATF, 2011:9). In its 2009 report, Transparency International noted that it has been estimated that the corrupt leaders of developing countries embezzle as much as 40% of the funds intended for the budgets of their countries, while 70% of their people survive on less than a $1 per day (Mugarura, 2010:275).

It has also been noted by the FATF, that an efficient AML framework can lead to the detection of the gains arising from corruption and, thus, it becomes possible to prevent those who are guilty of corruption from accessing these funds. An efficient AML framework would include an evaluation of all corruption-linked risks and would thus serve as a safeguard against the ML of funds derived from corruption (FATF, 2012b:3, 4).

AML frameworks can be extremely effective in the fight against corruption, while issues such as financial information and asset forfeiture requirements may be very helpful in following the flow of funds in cases of corruption (Sharman & Chaikin, 2009:43).

> Prescribing regimes without the will to enforce them cannot go far in forestalling the **twin threats** of corruption and ML. Therefore, there must be affirmative action on corruption by denying corrupt leaders an opportunity to secure stolen assets in any country (Mugarura, 2010:278).

2.6 THE RELEVANCE OF MONEY LAUNDERING TO POLITICALLY EXPOSED PERSONS

The FATF 40 + 9 has indicated that PEPs constitute a distinct type of customer that should always be labelled as a high risk for ML (Greenberg et al., 2010:13).

If an individual is classified as a PEP this does not, in any way, indicate that such a person is corrupt or has been involved in corruption. However, it is essential that FI be sensitive to the fact that there is an ongoing risk of ML being committed by either domestic or foreign PEPs. Accordingly, FI should be aware that the issue of having a PEP as a customer should be addressed appropriately in view of the possible risks of ML being linked to PEPs and their transactions (FATF, 2012b:8). In the FATF Report on Money Laundering Typologies of 2004, the following comments were made with regard to the ML risks that PEPS may pose:

> [T]he sources for the funds that a PEP may try to launder are not only bribes, illegal kickbacks and other directly corruption-related proceeds but also may be embezzlement or outright theft of State assets or funds from political parties and unions, as well as tax fraud. Indeed, in certain cases, a PEP may be directly implicated in other types of illegal activities such as organised crime or narcotics trafficking. PEPs that come from countries or regions where corruption is endemic, organised and systemic seem to present the greatest risk; however it should be noted that corrupt or dishonest PEPs can be found in almost any country (FATF, 2004a:19).

PEPs in autocratic governments constitute the greatest risk of ML, particularly in cases in which the PEPs have total control of the regime's functional powers. This enables corrupt PEPs to avoid having their illegally gained funds detected, because they have complete power both to hide and to transfer these funds to foreign jurisdictions and to FI. It is often only when a change of government takes place that such ML is discovered (FATF, 2012b:10).

Chris Kuruneri, Zimbabwe's Minister of Finance, is a typical example of the way in which a PEP's control over government functions can lead to corruption. In 2002, Kuruneri withdrew R5,2 million illegally from the Jewel Bank in Zimbabwe and transferred the money to attorneys in Cape Town, who then facilitated the purchase of a Cape Town property valued at R30 million in the name of a shell company (Goredema,2004:4).

Another typical example of corruption on a grand scale is the case of Abacha, the president of Nigeria from 1993 to 2000. Abacha approved false funding requests for his security advisor and this enabled him to move cash in truck loads out of the country. It is estimated that, during his reign, he embezzled between $2 and $4 billion. It was his control over the entire Nigerian government that enabled him to embezzle these funds and to launder them successfully (FATF 2011:27, 30).

The World Bank has estimated that, yearly, $1 trillion in corrupt funds are being moved transnationally annually without being detected. It has also become clear that corrupt PEPs are employing more complex techniques to hide the proceeds of their corruption while international compliance with PEP requirements is also inadequate. These factors all contribute to these illegally gained funds flowing through FI without being detected (Greenberg et al., 2010:17).

2.7 SUMMARY

ML may be described as the process in terms of which criminals attempt to make it appear that the proceeds of their crimes are actually funds or assets which have been obtained legally. They do this by trying to hide and disguise the true nature of the origins of such funds or assets (Bachus, 2004:1).

The significance of ML is that it enables criminals to grow their operations and to expand into other areas of crime. ML may have a devastating effect on FI. However, in view of the vast amounts of money involved in ML, it is receiving increased attention in the world (Levi, 2002:183,184).

Sophisticated international financial systems have, in the past few decades, enabled trillions of US dollars to be moved, without hindrance, between countries, literally within seconds. However, this innovation has also enabled criminals to ensure that their illegally gained funds are transferred around the world in the same short amount of time. These increased abilities of organised crime have obliged governments to place AML measures as a priority on their agendas. ML is regarded as an international challenge as it may destabilise international economic functions and penetrate legal frameworks. Countries with a poor track record of good governance may also become havens for organised crime (Haigner et al., 2012:1).

Corruption and ML have become increasingly interrelated, with issues such as drug trafficking, illegal weapons and currency trafficking, as well as the abuse of government

funds, escalating the problem to an international level. It has been noted that an escalation in both ML and corruption is associated with criminals resorting to corruption in cases in which their traditional forms of crime are no longer effective. Thus, where corruption is rife, it is extremely difficult to ensure the effective implementation of AML systems (Mugarura, 2010:273, 274). The FATF 40 + 9 on PEPs is crucial as regards dealing with corruption as these individuals have access to large amounts of money in their governments and should, therefore, be labelled as high risk customers (Oduor, 2010:12). Despite the fact that not all PEPs are corrupt, those who are may, potentially, have access to vast sums of money gained illegally and which they would want to inject into financial systems. Ultimately, they would want to have access to these funds by ensuring that the funds appear to have been acquired in a legal manner (De Klerk, 2007:369).

> Every year, developing countries lose approximately $1.3 trillion in illicit financial outflows – the proceeds of crime, corruption, tax evasion, and trade mispricing. This loss of capital outpaces current levels of foreign aid by a ratio of 10 to 1. Curtailing these outflows is crucial to nurturing a stable and robust economic recovery in global markets, stamping out political corruption and crime, and fostering good governance (Message to the G-20 Task Force on Financial Integrity and Economic Development 2011) (FATF,2011a).

The Director General of the South African Public Services Commission reported to the South African Parliament in November 2012 that financial transgressions in the South African government had escalated from R100 million in the 2008/09 financial year to R932 million in the 2010/11 financial year. It was noted that figures for the financial transgressions and corruption of public servants were not available for the 2011/12 financial year, although the hope has been expressed that, when released, the amount involved would not exceed the R1 billion mark (Ensor, 2012).

Developing countries cannot afford the damaging and treacherous effects that ML and grand corruption have on their growth. These effects are far reaching as governments lose credibility, the reputations of FI are tarnished and foreign investors no longer trust the moral compass of the government concerned. These factors, in turn, lead to capital flight which has a far-reaching effect by stunting the growth of the economy. In addition, any, attempts to eradicate poverty are futile and inequalities increase. A corrupt government's ability to extend its rule of a country will lead to the scale of these problems increasing with the residual effects lasting for an extended period of time. One possible solution to this problem

is for governments to display the “political will’’ required to combat corruption and fight ML in the areas under their jurisdiction (Greenberg et al., 2010: XIII).

CHAPTER 3: INTERNATIONAL ANTI-MONEY LAUNDERING REGULATORY FRAMEWORKS

3.1 THE FINANCIAL ACTION TASK FORCE

In 1988, the General Assembly of the United Nations committed itself to eradicating ML and, subsequently, in 1989, at the summit of the G7 counties in Paris, the FATF was created. Although the FATF is currently based at the offices of the Organisation for Economic Cooperation and Development (OECD), which is located in Paris, it remains an independent organisation (Haigner et al., 2012:38).

Internationally the FATF comprises 34 member jurisdictions and two regional organisations and, as such, the FATF encompasses the largest financial centres. The members of the FATF include the United States, China, Australia, the United Kingdom, Canada and South Africa. There are also eight associate members, known as FSRBs, and these include the Asia/Pacific Group on ML, the ESAAMLG, the FATF on ML in South America and the Middle East and North Africa FATF. These FSRBs were created to ensure that non-member countries are included in the fight against both ML and TF (Haigner et al., 2012:39). In addition, there are international organisations which, as a result of their AML duties, have observer status. These include, among others, the African Development Bank, the Basel Committee on Banking Supervision, the Egmont Group of Financial Intelligence Units, the IMF, the UNODC, the IOSCO and the World Bank (FATF, 2012g). The aim of the FATF is to create benchmarks and to recommend how measures in the fight against ML, TF and the financing of the proliferation of weapons of mass destruction, may be implemented efficiently on a legal, operational and regulatory level (FATF 2012a:7). In Washington on 20 April 2012, the representatives of the FATF extended the FATF's mandate, for a period of eight years, reiterating that it is the international standard-setter for AML/CFT measures and for combating the financing of the proliferation of weapons of mass destruction (FATF, 2012d:10).

As part of its mandate to combat ML, the FATF formulated the first Forty Recommendations in 1990. These were revised in 1996 so as to ensure that they remained relevant to the ever-changing ways in which criminal were laundering money. The first revised set of Recommendations was approved by more than 130 countries, and became known as the international AML standard. After the September 11, 2001 attacks in New York, the FATF's mandate was expanded to include the financing of terrorism. This involved the formulation

of the Eight (later Nine) Special Recommendations on Terrorist Financing, to be used in conjunction with the existing Recommendations (FATF, 2010b:2).

In 2003, the FATF Recommendations were revised for the second time, and were approved by more than 180 countries as the global standard for AML/CFT. The latest revision of the FATF Recommendations was published in 2012. The FATFR were created in conjunction with the FSRBs, the IMF, the World Bank and the United Nations. The purpose of the FATFR was to come into line with new and emerging dangers and to provide clarity to the requirements contained therein. These Recommendations contain, among other things, procedures that will supplement the requirements involved in identifying the beneficial owner of legal persons and transactions. Measures are also provided to deal with those individuals that have prominent positions in government or large international organisations and who, because of their powerful positions and access to funds, are susceptible to corruption. Countries are now required to enhance their RBAs in determining the ML and TF risks that they face in order to enable them to focus on high risk areas (FATF, 2012a:7, 8).

The purpose of the Recommendations is to ensure that countries adopt processes to ensure that ML risks are identified and tracked appropriately .These countries are required to implement ways to prevent ML from occurring in the financial and other designated business areas, and to invest powers and duties in those authorities dealing with AML matters. In addition, these countries are to adhere to increased requirements in respect of greater transparency as regards the beneficial ownership of legal persons, and to assist with international cooperation in AML/CFT measures(FATF, 2012a:7).

In order to ensure that countries comply with the Recommendations, the FATF undertakes mutual evaluations, together with its FSRBs (FATF, 2010b:2). The in-depth manner in which these mutual evaluations have been conducted indicates the advances in the FATF's methodology in conducting the mutual evaluation reports. This, in turn, has contributed to the development and enhancement of the FATF Recommendations. The mutual evaluations are conducted by an average of 5 assessors during a two week, on-site evaluation of a country's compliance with the FATF 40 + 9. The assessors use more than 285 essential criteria to determine whether a country's legal and regulatory frameworks comply with the FATF 40 + 9, and to determine the level of implementation of these frameworks with each FATF Recommendation being scored on a four point scale, namely,

non-compliant, partially compliant, largely compliant and compliant. A rating of compliant is awarded only if there is full compliance with all the vital principles (IMF, 2011:6, 7).

Three rounds of mutual evaluations have already taken place and, in conjunction with the FATFR, the fourth round of mutual evaluations will commence in the latter part of 2013. The FATF has indicated that the fourth round will include a greater focus on countries' practical implementation of the FATFR (FATF, 2012d:20).

In addition to conducting mutual evaluation reports and follow-up reports on these mutual evaluation reports, the FATF issues guidance reports for government and the private sector as regards following an RBA; publishes typologies reports that deals with new ways of committing ML and new trends in ML, and issues guidelines for countries on how to implement the FATF Recommendations and the United Nations Security Council Resolutions (FATF, 2010c:5).

The FATF issues two public documents three times annually, in which countries which are regarded as high-risk and non-cooperative jurisdictions may be identified publicly. In the FATF Public Statement document, the FATF names countries that appear to have intentionally not put any AML/CFT procedures in place. Counter-measures are then applied to these countries if they either make no attempt to address these inadequacies or they do not indicate that they will address the inadequacies by means of "an action plan", in cooperation with the FATF. The other FATF document, known as *"Improving Global AML/CFT Compliance: On-going Process",* names countries that have cooperated with the FATF in addressing their AML/CFT insufficiencies by implementing an action plan devised by the FATF (FATF,2012h). The FATF 40 + 9 stipulates the basic AML/CFT measures that countries must adopt in accordance with their unique conditions and regulatory environments. It also indicates precautionary actions that FI should undertake in their AML/CFT efforts (FATF, 2003b:2).

The first four Recommendations of the FATF 40 + 9 contain measures that countries must adopt to criminalise ML, ensure the confiscation of the proceeds of crime and prevent ML. (FATF, 2003b:3,4) The following two Recommendations, which address CDD and EDD for PEPs, applies specifically to FI (FATF, 2003b:4, 5).

The link between money laundering and corruption compelled the FATF to include measures on PEPs in FATF 40 + 9 (Johnson, 2008a:292). The FATF 40 + 9 defines PEPs as persons who are or have in the past "been entrusted with prominent public functions in a

foreign country". Family members of PEPs as well as their close associates are also included in the definition as they are presumed to represent reputational risks akin to those represented by PEPs. However, PEPs who occupy middle and junior positions in public service are excluded from the definition (FATF, 2003b:17).

3.2 THIRD EUROPEAN UNION ANTI- MONEY LAUNDERING DIRECTIVE

3.2.1 Regulatory framework

As part of its commitment to ensure that the FATF Recommendations are adopted, the EU has, to date, issued three money laundering directives. The First ML Directive was focused on preventing the illegal proceeds of drug trafficking from entering the financial systems. This was accomplished by, among other things, requiring FI to address issues including CDD and record keeping, to report suspicious transactions and to train their employees in AML measures. The ambit of these AML measures was increased In the Second Directive to provide for all predicate offences which required suspicious transaction reporting. In addition, the measures were made applicable to certain non-financial activities and professions. The Third AMLD replaced the previous two directives. The aim of this Third AMLD was to implement the FATF 40 + 9 (FSA, 2012a).

The Third AMLD, issued under Directive number 2005/60/EC, aimed to prevent the use of the financial system for the purposes of both ML and TF, and came into force on 15 December 2005. It was addressed to the EU member states and stipulated that they should have adopted the directive by 15 December 2007 (European Parliament and the Council of the European Union [European Union], 2005: L309/32).

The Third AMLD states that the definition of ML, as contained in the First Directive, is still applicable but with the important difference that all serious crimes would now be regarded as predicate offences for the purposes of ML. Article 3(5) of the Third AMLD defines these crimes as "all offences which are punishable by deprivation of liberty or a detention order for a maximum of more than one year or, as regards those States which have a minimum threshold for offences in their legal system, all offences punishable by deprivation of liberty or a detention order for a minimum of more than six months" (Rietrae, 2007:16, 17).

While the previous two directives were rule based, the Third AMLD adopted an RBA. Accordingly, risk became the main element of the Third AMLD, requiring that all institutions subject to this directive should implement AML/CFT measures that are equivalent to the

risks that are being faced and, thus, that resources should be applied in order to ensure that the highest risk areas receive the most attention (Van den Broek, 2011:170–172).

3.2.2 Application of the Third Anti-Money Laundering Directive

A definitive framework for PEPs was created in the Third AMLD, together with its implementing directive, and which has specific application as regards the EU Member States. The legal PEP framework was based on the FATF 40 + 9, but contains some variances in that EDD is required only in the case of PEPs living in a foreign country and also the requirements are applicable for one year only after a PEP has ceased to function in as a PEP (Greenberg et al., 2010:19).

An important amendment in the Third AMLD is that trust and company service providers will be regulated in terms of the Third AMLD, thus indicating that the Directive now applied to certain categories of persons, and not certain activities. FI are referred to as entities that engage in activities such as money broking, commercial lending and financial leasing. In addition, persons involved in dealing with goods for which cash payments of 15 000 Euros or more may be made, are also now regulated by the Directive (Borlini, 2012:35, 36).

Thus, the scope of the Directive was expanded beyond the financial services system to include casinos, estate agents, accountants and lawyers. CDD measures were broadened in that they now require the establishment of the intent and type of business relationship with the ongoing monitoring of such relationships, extending to new and existing customers, the identification and verification of the identities of beneficial owners, the exemption of low risk circumstances from CDD and enhanced CDD in high risk circumstances such as dealing with PEPs. The Directive also stipulates specific duties for those entities which are required to have AML measures in place in order to address risk management and compliance (FSA, 2012a). An absolute prohibition is also placed on entities as regards maintaining anonymous accounts or entering into correspondent banking relationships, where banks provide banking services to each other, with either a shell bank or a bank that allows its accounts to be used by shell banks. Furthermore, member states are required to ensure that any contravention of AML legislation adopted as a result of the Directive will lead to liability on the part of the infringer with fines that will be efficient and commensurate with the crime and serve to discourage future infringements (Borlini, 2012:41).

It is incumbent on EU countries to establish FIUs, which will be mandated to request, receive and analyse information received on ML and TF. Any suspicion of ML should be

reported to these FIUs in the form of suspicious transaction reports, while these regulated entities may not then proceed with the transaction. The fact that a suspicious transaction report will have been filed may not be disclosed to the customer. Records must be kept for five years after the business relationship has been terminated. Where entities regulated by this Directive have branches and majority owned subsidiaries in third countries, the CDD and record keeping requirements are also applicable to these regions (European Union, 2012b).

Research has indicated that most of the EU member states have adopted the Directive and have created regulatory frameworks that are even more stringent. These stricter requirements vary from one member states to another, and have proved to be problematic as regards compliance-related matters when borders are crossed. Member states have reported that the implementation of the RBA has proved to be a challenge as the guidance provided thereon has been inadequate (European Commission: Deloitte, 2009:5).

3.2.3 Supervision

Section 2 of the Third AMLD deals with supervisory functions in the member states with the detail required being contained in articles 36 and 37 thereof. Member states must ensure that casinos, trust and company service providers, currency exchange offices and money transmission offices are licensed to operate as such in their jurisdictions. Licensing of these entities should be refused if it has been determined that the managers or beneficial owners of these entities are not fit and proper persons (European Union, 2005: L309/30).

As compared to the previous Directives, the Third AMLD embodies an increased focus on both supervision and enforcement and this, in turn, demonstrates the EU's expanded participation in the implementation of its AML/CFT measures. In this regard specific sections of the Third AMLD are now aimed at both supervision and enforcement while the relevant supervisory authorities of the respective states must monitor compliance with the Third AMLD as well as with CDD, reporting and record keeping measures. Thus, it is essential that competent authorities be empowered to ensure compliance with the Third AMLD (Van den Broek, 2011:177, 178).

Member states must devise their own frameworks as regards the supervision of their compliance with the Third AMLD. However, the consequence of this is that member states will have in place different administrative bodies which will be responsible for such supervision. Nevertheless, it is vital that these various supervisory bodies coordinate their

efforts to ensure the success of the Third AMLD. In this regard the European Commission has requested the European Union's banking, insurance and securities committees to coordinate their supervisory functions in respect of AML/CFT (Rietrae, 2007:35).

It became evident that the EU was committed to the fight against ML by its adopting the regulatory frameworks soon after the FATF had formulated the Recommendations. However, the adoption of these standards by the EU proved to be challenging as certain legal and constitutional issues came to the fore, including whether the EU had the capability to implement certain international standards, as well as the protection of civil liberties and basic rights, with ML and TF becoming matters of security (Mitsilegas & Gilmore, 2007:140).

MONEYVAL, the Committee of Experts on the Evaluation of AML Measures and the Financing of Terrorism, has been mandated to ensure that EU member states implement efficient AML/CFT measures, which are in accordance with both the FATF Recommendations and other international AML systems. MONEYVAL, in a similar fashion to the FATF, undertakes mutual evaluation reports of member states. These reports provide assistance to the Member States on how to improve the efficiency of their AML measures. In addition, MONEYVAL undertakes typology studies on ML trends. MONEYVAL will also propose measures to improve the AML/CFT regulatory framework of the EU to the Committee of Ministers. MONEYVAL is an associate member of the FATF and, thus, it assists in the international efforts to combat ML (European Union, 2012b)

3.3 THE REGULATORY FRAMEWORK OF THE UNITED KINGDOM

3.3.1 The regulatory framework

The United Kingdom has member status with the FATF. In addition, in view of the position of London as a "major financial centre", it is not surprising that the United Kingdom has a pivotal role to play in the creation of AML/CFT measures. The legal framework for AML in the United Kingdom is encompassed in the regulatory, civil and criminal law systems of the country. There are three core bodies in the United Kingdom which are tasked with fighting ML, namely, the United Kingdom Government which drafts laws stating what constitutes crimes and creating the requisite MLR; the FSA which is responsible for formulating the AML rules; and the JMLSG which is tasked with providing guidance notes on the MLR, and how to best apply the MLR (Leong, 2007:141, 142). In terms of the Financial Services and Markets Act 2000, the FSA has a further mandate to ensure that financial crime is reduced,

and, in addition to its function, to ensure that “treating customers fairly” is implemented by the financial systems in the United Kingdom. This, in turn, has led to the FSA’s rulebook being unique as compared with the rule books of other international regulators, which do not provide for specific fair treatment of customers (Cox, 2011:63).

The FSA has formulated AML rules which are in keeping with the regulatory requirements of the MLR. The five core obligations imposed on firms include KYC, the duty to maintain records, the appointment of an ML reporting officer, the reporting of suspicious activities and the implementation of AML procedures. Where the MLR have been contravened, the FSA has the authority to conduct criminal prosecutions for such breaches (Leong, 2007:144).

The present AML/CFT regulatory framework of the United Kingdom is embodied in the Proceeds of Crime Act 2002 and the MLR (Rhodes & Palastrand, 2005:9).

The FIU operates under the auspices of the Serious Organised Crime Agency, although it is largely independent. The Third FATF Mutual Evaluation Report on the United Kingdom indicated that, in the main, the FATF regarded the FIU as compliant with Recommendation 26 of the FATF 40 + 9 and efficient overall (FATF, 2007b:6).

ML prosecutions between 1999 and 2007 totalled 7 569, of which 3 796 led to convictions. The number of ML prosecutions has been escalating every year (Alkaabi, Mohay, Mccullagh & Chantler, 2010:8)

The Proceeds of Crime Act 2002 was promulgated with the aim of ensuring that any financial advantage that criminals gained from their crimes could be recovered by the authorities. Accordingly, the legislators took care that this legislation defined ML crimes. The crime of ML would apply to the proceeds of all illegal activities, and, thus, an all-crimes approach is adopted. The Act requires that the financial system’s gate keepers report suspicious activities and permits asset forfeiture where it is suspected that the assets in question were the proceeds of crime. The Act also established the Asset Recovery Agency, which may legally attach assets gained from crime (Sevgel, 2012:100).

3.3.2 Application of the United Kingdom's regulatory framework

The MLR were adopted in 2007 as part of the United Kingdom's efforts to improve its AML/CFT regulatory framework, to be in alignment with the FATF 40 + 9 and to give partial effect to the Third AMLD (IMF, 2011b:5). All FI, as defined by the FATF 40 + 9, are regulated by the MLR (FATF, 2007b:158). The MLR apply to accountants, auditors, lawyers, trust or company service providers, estate agents and high value dealers. The MLR also regulate all 13 "financial activities "conducted by entities, as identified by the FATF 40 + 9. The regulation of designated non-financial businesses and professions are also covered by the MLR (FATF, 2009:5).

The MLR also indicate the measures that must be adopted as regards identifying customers, CDD, determining beneficial ownership as well as the reason why a customer would want to enter into a business relationship with a regulated entity. In accordance with the FATF 40 + 9, the MLR further provide for continued due diligence and EDD in circumstances that are regarded as high-risk for the purposes of ML. PEP regulation is one of the new requirements that are contained in the MLR (FATF, 2009:7-9). PEP regulation was included in the 2007 MLR as the FATF's Third Mutual Evaluation Report of the United Kingdom in 2007 had indicated that the country was non-compliant with regard to Recommendation 6 of the FATF 40 + 9, as no enforceable PEP obligations were contained in any of the United Kingdom's regulatory frameworks (FATF, 2007b:127).

An important aspect of the MLR is that the MLR established the RBA to AML in the United Kingdom regulatory framework, as the United Kingdom Government had indicated that the RBA to AML was indispensable to the efficient running of its AML system (Sevgel, 2012:106).

The MLR require that policies and procedures that address risk management processes be adopted and these policies and procedures should specifically include a requirement that there is a duty, at all times, to determine whether a customer is a PEP (United Kingdom. The Money Laundering Regulations [MLR], 2007:20).

In respect of the United Kingdom's AML/CFT's regulatory framework, additional guidance from certain bodies has been welcomed, with guidance published by the following entities being approved and officially acknowledged in the MLR; namely, JMLSG, HMRC, the Committee for Accountancy Bodies and the Notary Profession. The FSA's Handbook of

Rules and Guidance also contains specific reference to industry guidance that had been approved by the Government of the United Kingdom (FATF, 2009:5).

The JMLSG is made up of the most prominent United Kingdom Trade Associations and is led by the British Bankers' Association. The JMLSG has been mandated to create guidance on the MLR and, in this regard, it issues ML Guidance Notes for firms rendering financial services. Courts may also use these ML Guidance Notes as evidence that the MLR have been contravened or that suspicions of ML are reasonable. The Guidance Notes provide a summary of the ML laws in the United Kingdom, assist with practical implementation of the MLR, explain the FSA ML rules, indicate what is regarded as best practice and provide a framework for businesses in terms of which they may to develop their own AML policies and procedures (Leong, 2007:144).

3.3.3 Supervision

FI, as defined in the FATF 40 + 9, are regulated for the purposes of AML/CFT by the FSA (FATF, 2007b:157). HMRC acts as the supervisory authority for all trust and company services providers, including their directors, managers, staff members, proprietors and nominated officers (HMRC, 2010:1) The Office of Fair Trade acts as the supervisory authority for estate agents and consumer credit FI while the Secretary of State acts as the supervisory body for insolvency practitioners. Casinos are supervised by the Gambling Commission, while the Department of Enterprise, Trade and Investment in Northern Ireland acts as the supervisory authority of credit unions and insolvency practitioners in Northern Ireland. In addition to HMRC, Her Majesty's Commissioners also supervise high value dealers, money services businesses and auditors, accountants and tax advisers that are not otherwise supervised (MLR, 2007:22). Schedule 3 of the MLR further lists various professional bodies that acts as supervisors, including various Law Societies and Institutes of Chartered Accountants (MLR, 2007:42, 43). Supervisory bodies follow the FATF 40 + 9 in that an RBA is applied to their supervisory functions (HMT, 2013:9).

The Senior Management Arrangements, Systems and Controls Rules of the FSA contain requirements in respect of the AML measures that FI should implement. These include the stipulation that FI should have procedures in place to manage their ML risk. These procedures should include staff training in AML requirements, the board should receive annual feedback on the firm's AML measures and it is the responsibility of senior management to devise efficient AML measures, such as the ML reporting officer (Cox, 2011:64, 65).

3.4 SUMMARY

As part of its mandate the FATF must create benchmarks and recommend how measures aimed at combating ML, TF and the financing of the proliferation of weapons of mass destruction, may be implemented efficiently on a legal, operational and regulatory level (FATF, 2012a:7).

The Recommendations, which are regarded as the international standard on AML, have, as their main purpose, that countries should adopt processes to ensure that ML risks are identified and tracked appropriately (FATF, 2012a:7). The FATF 40 + 9 includes the basic AML/CFT measures that countries must adopt in accordance with their unique circumstances and regulatory environments. It also contains precautionary actions that FI should undertake in their AML/CFT efforts (FATF, 2003b:2). An increased focus on the link between money laundering and corruption compelled the FATF to include measures on PEPs in its FATF 40 + 9 (Johnson, 2008a:292).

As part of its commitment to ensuring that the FATF Recommendations are adopted, the EU has, to date, issued three Money Laundering Directives. The Third AMLD replaced the previous two and has, as its aim, the implementation of the FATF 40 + 9 (FSA, 2012a).

The Third AMLD was issued with the aim of preventing the use of the financial system for ML and TF. It applies to all the EU member states and requires that they ensure that the Directive is adopted in their respective jurisdictions (European Union, 2005:L309/32). The EU member states have adopted the Directive and have created regulatory frameworks that, in the majority of cases, are more stringent than is required in terms of the Directive (European Commission. Deloitte, 2009:5).

The AML/CFT regulatory framework of the United Kingdom is embodied in the Proceeds of Crime Act 2002 and the MLR (Rhodes & Palastrand, 2005:9). The MLR were adopted in 2007 as part of the United Kingdom's effort to improve its AML/CFT regulatory framework, to be in alignment with the FATF 40 + 9 and to give partial effect to the Third AMLD (IMF, 2011b:5).

The FATF 40 + 9 comprise recommendations to which countries must commit by incorporating these recommendations in their regulatory frameworks. On the other hand, the Third AMLD is compulsory for all EU member states. The Third AMLD adopts an all crimes approach to ML, whereas the FATF 40 + 9 indicate various ways in which predicate crimes of ML may be identified. The FATF 40 + 9 also contains a specific list of serious

crimes which are regarded as predicate offences (Rietrae, 2007:39, 40). The Third AMLD acts as a “preventive legislative framework” in respect of ML, but the success of this Directive depends entirely on whether the EU member states apply it in their own regulatory frameworks in an efficient manner (Rietrae, 2007:41).

CHAPTER 4: THE SOUTH AFRICAN ANTI-MONEY LAUNDERING REGULATORY FRAMEWORK

4.1 THE REGULATORY FRAMEWORK RELEVANT TO ANTI-MONEY LAUNDERING AND COMBATING THE FINANCE OF TERRORISM IN SOUTH AFRICA

The international fight against drug trafficking and its illegal proceeds in the 1990s caused South Africa to broaden the scope in respect of its criminal law in an effort to combat the ML that would occur as a result of the illegal trade in drugs. The Drugs and Drug Trafficking Act 140 of 1992 was a result of this effort. It defined laundering crimes but achieved little success as it was limited to drug-related crimes. Accordingly, an all crimes approach was then adopted and the Proceeds of Crime Act was issued in 1996. This Act specified that any gains from crime would constitute the crime of ML. The abovementioned acts were replaced with the POCA in 1998. The aim of POCA was that all ML crimes would be combined in one Act (De Koker, 2003:166). The POCA contains three specific provisions that criminalise ML and provide for the conversion, transfer, concealment, hiding, possession or obtaining of property. These provisions are in accordance with the requirements of the Vienna and Palermo Conventions (FATF & ESAAMLG, 2009:6).

The POCDATARA stipulates CFT measures and was promulgated in 2004 while the FICA was promulgated in 2001 and amended in 2008. The POCA, POCDATARA and FICA all work together in South Africa's fight against ML and TF (FIC, 2012:6). The AML Regulations became effective in 2003 and required, among other things, that FI which were regulated in terms of the FICA were obliged to identify and verify customers with whom they were conducting business. These regulated FI, also known as accountable institutions, are further provided with detailed requirements as regards record keeping, client profiling, the reporting of suspicious transactions and the establishment of Internal Rules in these Regulations (South Africa. Regulations in terms of the Financial Intelligence Centre Act [Regulations], 2003:1, 3).

South Africa's AML/CFT measures are expanded in the Guidance Notes issued by the FIC. However, these Guidance Notes do not comply with the FATF's requirement of other "other enforceable means" as they are not regarded as legally enforceable. Accordingly, despite the fact that their introductions indicate that that they are authoritative, they also proceed to indicate that they should be used for information purposes only (FATF & ESAAMLG, 2009:88).

In 2010, the Financial Intelligence Centre (FIC) commenced with the issue of a Public Compliance Communication series, to assist all businesses with a “better understanding” of the FICA. Thus, the aim of this series is to provide clarification of a legal nature on matters regarding which all businesses have experienced problems of compliance in their implementation of the FICA (FIC, 2010a:1, 2). In section 4(c), the FICA provides that the FIC may issue guidance on its interpretation of the FICA. The Public Compliance Communications have been issued in this regard, and are described by the FIC as its views on challenging issues experienced in the administration of the FICA. The FIC has also indicated that the Public Compliance Communications have the same standing as the Guidance Notes in that they are authoritative but should not be construed as legal advice. It is envisaged that these Public Compliance Communications will support accountable institutions in comprehending their duties with regard to the FICA (FIC, 2010b:1, 2).

The FICA was responsible for the creation of the FIC with the purpose of identifying illegally acquired funds, combating ML and TF and providing intelligence to national and international organisations and also to South Africa’s police force, tax authorities and intelligence services. The FIC is also responsible for the supervision and enforcement of the FICA (FIC, 2012:6).

The FIC acts as South Africa’s FIU and its core functions relate to providing guidance to accountable and reporting institutions as well as to supervisory bodies with regard to their compliance with the FICA, conducting research on information that the FIC obtains, reporting to the Minister of Finance, providing suggestions to the Minister of Finance based on the information it has obtained and assisting in the international measures against ML and TF. In addition, it has been mandated to safeguard the integrity and stability of the South African financial system. It does this by, among other things, providing financial intelligence for law enforcement agencies. The FIC also manages the regulatory framework for AML /CFT in South Africa and, as such, has led the South African delegation to the FATF (FIC, 2012:6, 7).

In 2003, the FIC joined the Egmont Group of Financial Intelligence Units and, as a result, is well able to analyse any suspicious transactions reported to it in view of its access to a vast amount of administrative, financial and law enforcement information (FATF & ESAAMLG, 2009:7).

In August 2002, South Africa joined the ESAAMLG as a full and active member. Membership of ESAAMLG had been a prerequisite for membership of the FATF. South

Africa had made a written commitment to the FATF in 2002 that it would endorse the Forty Recommendations; submit itself to Mutual Evaluation Reports and to be committed to the fight against ML in its territory. The FATF's first mutual evaluation of South Africa took place in 2003 in order to confirm that South Africa had, indeed, implemented the requisite AML measures, which was a further prerequisite for FATF membership. Based on the result of the Mutual Evaluation Report, which considered the AML measures initiated by the country, South Africa was admitted as member of the FATF in 2003 (FATF, 2003a: 10, 14). South Africa is currently the only African member of the FATF (FIC, 2011:10).

4.2 DUTIES IN TERMS OF THE FINANCIAL INTELLIGENCE CENTRE ACT

The FICA has stipulated the duties to be performed by certain FI which are referred to as accountable and reporting institutions. However, there are also duties which are applicable to all businesses. Accountable institutions include banks, long term insurance companies, estate agents, attorneys, auditors and financial advisers dealing with investments while reporting institutions include motor dealers and dealers in Kruger Rands (De Koker, 2003:168).

ALL BUSINESSES

Where an individual is the owner of a business, or manages such a business, the only duty of such an individual, in terms of the FICA, is to report suspicious or unusual transactions to the FIC (FICA, Section 29).

REPORTING INSTITUTIONS

It is incumbent on motor dealers and dealers in Kruger Rands to report cash transactions over R24 999 to the FIC (FICA, Section 28). Reporting institutions also have to report any suspicious or unusual transaction to the FIC (FIC, 2008:9, 10). These reporting institutions must register with the FIC within the prescribed period (FICA, Section 43B).

ACCOUNTABLE INSTITUTIONS

4.2.1 Duty to establish and verify the identity of clients.

The FICA contains important governing measures which are an integral part of its overall aim to combat ML and TF. One of the most important of these measures is that accountable institutions have a duty to be familiar with the clients with whom they are engaging in business activities (FIC, GN1, n.d.:1).

Section 21 of the FICA stipulates that an accountable institution may not enter into a business relationship or complete a single transaction unless the identity of the client has been established and verified. This identifying and verifying process will also include instances in which a person is acting on behalf of a client (De Koker, 2003:170). Nevertheless, irrespective of this duty to identify the clients with whom they are doing business; accountable institutions do not have to determine the source of the client's funds, neither does the client's employment, net worth or business dealings have to be established. This may, however, impede efforts to risk rate a client for ML purposes and to determine when such a client's activities would be construed as either suspicious or unusual (De Koker, 2002:25, 26).

The ML and Terrorist Finance Control Regulations contain the procedures to be followed by accountable institutions on how to establish and verify the identities of their clients. The clients whose identities must to be established and verified are included in the regulations under the categories of South African citizens and residents, foreign persons, South African companies and close corporations, foreign companies, other legal persons, partnerships and trusts (FATF & ESAAMLG, 2009:91).

Domestic and foreign individuals

Section 3 of the Regulations issued in terms of the FICA require that accountable institutions should obtain, in respect of South African citizens and residents, details of such clients which include the client's full name, birth date, identity number and residential address (De Koker, 2006:717, 718). Where a person is acting on behalf of a person who does not have the legal capacity to establish a business relationship or to complete a single transaction, such a person's full name, birth date, identity number and residential address should also be obtained (Regulations, 2003:5, 6).

Once this information has been obtained, accountable institutions must verify the information obtained. The person's name, date of birth and identity number may be verified by comparing it with the identification document of such a person. The residential address of such a person may be verified by comparing it with data which may reasonably be expected to achieve such verification, where such data has been obtained by means of any reasonably practical method (De Koker, 2006:718).

However, the South African AML regulatory framework does not require that the identities of beneficial owners be either established or verified. CDD requirements are also waived in

certain low risk situations, as provided for in exemptions issued in terms of the FICA. In addition, the FICA does not require that the purpose of establishing a business relationship should be determined; neither does it require ongoing CDD or enhanced CDD for clients who are classified as high risk for the purposes of ML (FATF & ESAAMLG, 2009:8).

In instances in which accountable institutions engage with foreign individuals, the institutions must obtain the full name, date of birth, nationality, passport number and residential address of such persons. Where a person is acting on behalf of a foreign individual who does not have the legal capacity to establish a business relationship or to complete a single transaction, such a person's full name, birth date, identity number and residential address should also be obtained. The abovementioned information should be verified by comparing it with the identity document of such a foreign national. Accountable institutions should also use other independent sources, where deemed reasonably necessary, to verify the remainder of the information obtained regarding such a foreign individual (Regulations, 2003:6, 7).

However, in exemption 5 thereof, the Regulations provide that, where a client is situated in a foreign country in which the relevant South African supervisory body regards the foreign country's AML provisions to be comparable to the South African AML/CFT framework, that any institution or person which falls under such foreign country's AML regulation, may confirm in writing that the institution or person has verified the details of such a client. Such an institution or person must also undertake that it/he/she will forward all the documents procured in the process of verifying the client's identity to such an accountable institution (Regulations, 2003:47). It has been noted that certain accountable institutions use Exemption 5 to the extent that all foreign clients who reside in FATF member countries are fully exempted from verification requirements. This is the case irrespective of whether such an accountable institution has confirmed whether such a foreign country has a satisfactory AML/CFT framework. A further deficiency as regards the exemption is that there is no duty on the foreign person or institution that has confirmed the verification to provide the data immediately to the accountable institution. Similarly, accountable institutions have no duty to ensure that the CDD data is provided to them, as soon as possible, by the foreign institution (FATF & ESAAMLG, 2009:109).

The FICA and its Regulations provide that accountable institutions should establish the identity of their clients. However, the FICA and its Regulations are deficient in the sense that they do not provide that accountable institutions must obtain information that will

indicate possible suspicious behaviour on the part of their clients. It would be beneficial if the details of a client's employment, his/her business activities and source of funds could be obtained for this purpose (De Koker 2006:723)

Corporate vehicles

Regulations 7 to 15 of the FICA Regulations stipulate the Know Your Customer (KYC) requirements for legal entities, including South African and foreign companies, close corporations, trusts and partnerships. The KYC requirements stipulate that the registered name of the legal entity be provided, as well as its address and registration number. Furthermore, details of every individual who is authorised to act on behalf of the legal entity must be provided. Such details would include full names, identity number and residential address. Similar details must be obtained from the managers of the legal entity and all natural or legal persons who have more than 25% voting rights in such a legal entity (Regulations, 2003:7-15). The abovementioned information that has been obtained must be verified by, among other things, obtaining the official company documents for the legal entities. In the case of trusts, verification must take place via insight into the contents of the trust deed (De Koker, 2006:718).

KYC exemptions

The exemptions in terms of the FICA include 17 exemptions, some general and some specific, and which enable accountable institutions to adopt reduced or simplified CDD. Where the ML risk is lower, no CDD is required. This also applies to instances in which the information about the customer is publicly available. The FATF context does provide for reduced or simplified CDD, but it has been noted that these exemptions are too broad, with the result that the efficiency of the FICA and its regulations has been compromised (FATF & ESAAMLG, 2009:91, 92).

The application of an RBA to CDD is restricted in terms of the FICA, with the result that accountable institutions do not differentiate between high risk and low risk customers when applying their KYC procedures. Despite the fact that the FIC has issued guidance notes on applying an RBA to the identification of customers, accountable institutions may choose to follow an RBA as regards identifying clients. However, they do not have to follow a "one-size-fits-all "method (FIC, GN1, nd: 2).

4.2.2 Record-keeping duties

Sections 22 and 23 of the FICA stipulate the record-keeping duties of accountable institutions. These include the stipulation that records should be kept of the identification and verification of clients with whom business transactions have been entered into, irrespective of whether it was a single transaction. Records should be kept for a period of five years after the termination of the business relationship, or the conclusion of a transaction (FICA, Section 23).

4.2.3 Reporting duties

Accountable institutions must report cash transactions above R24 999 to the FIC, while section 28 of the FICA specifies that this would include cash paid to such an institution or paid by such an institution to a client. The purpose of this cash threshold reporting is to enable the FIC to screen and report on cash transactions that may be related to ML (FIC, 2010c:1, 2).

All accountable institutions must report suspicious and/or unusual transactions to the FIC. The duty to report in terms of section 29 becomes relevant when a person has knowledge of facts, or should reasonably have known or suspected that certain facts exist, which relate to ML or TF (FIC, 2008:9, 10). The suspicious transaction should be reported to the FIC within a certain timeframe and may include the fact that a business has received, or will receive, the proceeds of crime, that the transactions concluded may possibly lead to the proceeds of crime being transferred, that certain transactions concluded have no business or lawful aim, that the transactions are being concluded so as not to give rise to reporting duties under the FICA, that it would appear that the transactions are intended avoid tax duties or that the business will or has been used to further ML (De Koker, 2003:171, 172).

4.2.4 Further duties of accountable institutions

Accountable institutions must register themselves with the FIC within the prescribed period (FICA, Section 43B). They are further obliged, in terms of the FICA, to formulate internal rules that will address CDD, reporting obligations and record keeping. A compliance officer must also be appointed and will be responsible for monitoring and implementing AML/CFT measures in the business. Employers in accountable institutions must provide training to

employees to ensure that they comply both with the FICA and with the internal rules adopted by the business concerned (FATF & ESAAMLG, 2009:9).

4.3 SUPERVISORY BODIES

The FIC has not been authorised to supervise accountable institutions, as these supervisory duties have been assigned to supervisory bodies. It is the responsibility of every supervisory body to supervise compliance with South Africa's AML/CFT measures by the accountable institutions for which it is responsible (FICA, Section 45). The supervisory bodies are listed in Schedule 2 of the FICA and include the following institutions, namely, the National Gambling Board, Provincial Licensing Authority, Estate Agency Affairs Board, South African Reserve Bank, Financial Services Board, provincial law societies, Independent Regulatory Body for Auditors and the FIC (FIC, 2012:21). However, the range of AML/CFT supervision is not sufficient as certain FI, which are not defined as accountable institutions, will not be supervised (FATF & ESAAMLG, 2009:133). The FIC therefore acts as the supervisory body for the Postbank, trust companies and all reporting institutions. As part of its supervisory functions, compliance inspections are conducted. These may be either routine or non-routine. During these inspections questioning may take place, computer systems accessed and client files monitored to ensure compliance with the FICA requirements (FIC, 2012:21, 23).

These supervisory bodies adopt an RBA in supervising the organisations they oversee. In following this approach they must consider factors such as the size of the entity, operational issues, credit risk, corporate governance and the prevailing culture of compliance (FATF & ESAAMLG, 2009:28, 29).

4.4 SUMMARY

The South African AML regulatory framework comprises the POCA, POCDATARA and FICA (FIC, 2012:6). In accordance with the requirements of the Vienna and Palermo Conventions ML has been criminalised in terms of the POCA (FATF & ESAAMLG, 2009:6). The South African AML/CFT measures are contained in the FICA, its regulations and exemptions (FATF & ESAAMLG, 2009:8).

The FIC acts as South Africa's FIU, and has been mandated to safeguard the integrity and stability of the South African financial system. This is achieved by, among other things, providing financial intelligence to law enforcement agencies. The FIC is responsible for managing the regulatory framework for AML /CFT in South Africa (FIC, 2012:6, 7).

The FICA has stipulated duties to be performed by certain FI, which are referred to as accountable and reporting institutions. In addition, there are duties which are applicable to all businesses (De Koker, 2003:168). The KYC duties have been imposed on accountable institutions and require that these institutions may not enter into a business relationship or complete a single transaction unless the identity of the client has been established and verified (De Koker, 2003:170).

The FIC has not been authorised to supervise accountable institutions, as these supervisory duties have been assigned to supervisory bodies. It is the responsibility of every supervisory body to oversee compliance with South Africa's AML/CFT measures by the accountable institutions for which it is responsible (FICA, Section 45). The FIC acts as the supervisory body for the Postbank, trust companies and all reporting institutions (FIC, 2012:21, 23).

The FICA's AML/CFT measures are supplemented by Guidance Notes which are issued by the FIC. However, these do not comply with the FATF's requirement of other "other enforceable means" (FATF & ESAAMLG, 2009:88).

CHAPTER 5 A RISK BASED APPROACH TO ANTI- MONEY LAUNDERING

5.1 Introduction

In 1990, in order to combat ML through drug trafficking, the FATF issued its first Recommendations. These Recommendations instituted “a rule based AML system” (Ross & Hannan, 2007:108). Increased dissatisfaction with over-regulation, the costs related to compliance and the rigidity of rule-based regulation, resulted in a “regulatory crisis” in the 1980s and 1990s. This, in turn, contributed significantly to the emergence of risk–based regulation (Hutter, 2005:1). In terms of the RBA, regulated entities have the discretion to determine what they consider to be high risk situations, whether these are, in fact, cases of ML and whether such cases should be reported (Unger & Van Waarden, 2009:3). As regards an RBA to AML, the emphasis is on the real risk which, in turn, entails that regulated entities should adopt processes that are satisfactory and equivalent to the risk that has been identified; thus, resulting in the majority of resources being applied to the highest risk areas (Van den Broek, 2011:172).

The FATF 40 + 9 refers to risk as a requirement for consideration in Recommendations 5 and 24 thereof. Recommendation 5, which deals with CDD measures, indicates that these measures may be applied on a “risk sensitive basis”, to be determined by the category of client, the nature of a transaction or the business relationship (FATF, 2003:5). On the other hand, Recommendation 24 requires that countries also implement AML/CFT measures for other types of designated non-financial businesses and professions, on a “risk sensitive basis” (FATF, 2003b:10).

In implementing an RBA, risk management processes, which identify risks and assess risks, should be implemented. These risk management procedures should, moreover, provide for ways in which the risks that have been identified will be managed. Countries and institutions should all conduct risk analyses to identify the highest ML risks applicable to them while AML/CTF risk management procedures should ensure that ML does not take place. This is made possible by AML processes that will deter, detect ML and enable record keeping. In higher risk areas, these procedures should be enhanced, for example, by enhanced CDD (FATF, 2007a:2).

The FATFR, issued in 2012, require countries to adopt an RBA to both ML and the terrorist risk they face. Countries are required to focus their efforts on higher ML risks, thereby enabling them to use their AML resources more efficiently. The FATFR emphasises the

need to focus on high risk ML and TF situations. This requirement as regards following an RBA applies to all the Recommendations adopted in 2012 (FATF, 2012a:8). Recommendation 1 specifically requires that countries follow an RBA to AML which should be proportionate to the risks identified: "This approach should be an essential foundation to efficient allocation of resources across the ⋯ (AML/CFT) regime and the implementation of risk based measures throughout the FATF Recommendations" (FATF, 2012a:11).

The United Kingdom has adopted an RBA as regards the regulation of the financial services industry. The FSA uses an RBA in determining the degree to which FI should be supervised. This is determined by, among other things, the assets of the FI and the impact which the FI has on the financial services industry. The RBA applies to all regulated entities in that they may apply the JMLSG Guidance notes, as needed, in order to comply with the MLR and FSA Handbook requirements (FATF, 2007b:7).

The EU also introduced an RBA to AML in its Third AMLD (Leong, 2007:147). Where the First AMLD did not refer to an RBA, the Third AMLD indicates that EU member states may implement an RBA, with the three stages of risk being identified as normal CDD, EDD and simplified CDD (Rietrae, 2007:24).

The FICA does not specifically address the issue of the risk of ML. In addition, there are specific financial activities which are excluded from AML/CFT measures, irrespective of the risk ratings of these activities. Guidance Notes issued to banks and accountable institutions indicate that it is not necessary to adopt a "one-size-fits-all" rule to CDD, but that EDD should apply to higher risk situations only. Supervisory authorities do, however, adopt an RBA in their monitoring of regulated entities (FATF & ESAAMLG, 2009:88, 89).

The successful implementation of an RBA to AML requires that all ML risks be recognised and categorised and that appropriate measures be implemented to deal with these risks. A well-formulated RBA will afford FI the option of exercising their discretion when dealing with their clients and will not inhibit business dealings (FATF, 2007a:2, 3).

5.2 DEFINING RISK

The FATF's Global ML and Terrorist Financing Threat Assessment Report indicates that no universally accepted definition of risk in respect of AML/CFT exists (FATF, 2010a:13).

It has been suggested that risk may be defined as the "possibility of loss". Regulated entities may face two types of risk as regards AML/CFT, namely, "business risk" when such

an entity is used for ML purposes and this, in turn, results in the entity incurring "regulatory risk" for non-compliance with AML regulatory requirements (Sathye & Islam, 2011:176). Reputational risk is also an important consideration as regards applying an RBA to AML, as the damage that it may cause to a FI is not quantifiable and may even lead to the demise of such an institution (De Klerk, 2007:371.377).

The FSA has, as one of its core functions, the duty to protect consumers and, in this regard, has identified various risks that consumers may face. These risks include prudential risk, which is linked to the fact that a regulated entity may fail as a business, fraud risk, which refers to risks that consumers may purchase financial products that are too complicated for them to understand or which are not suitable to their needs, and the risk that investments do not perform as hoped. The FSA has accepted its mandate to mitigate all these risks, with the exception of the latter risk as investments are characterised by an inherent risk as regards performance (Stewart, 2005:44).

A crucial factor In the FATF 40 + 9 is the different levels of risk that are associated with certain types of clients or transactions. The RBA has been incorporated into the FATF 40 + 9 and, more specifically, risk has been addressed with regard to CDD in Recommendations 5, 6, 8 and 9. Risk in these Recommendations may be high risk, as set out in Recommendation 5 and which requires enhanced CDD for higher risk clients while Recommendation 6 deals with PEPs, a high risk situation that always requires EDD. Lower risks allow for FI to apply a simplified CDD. As required in Recommendations 8 and 9, where risks evolve and systems are created that may lead to anonymity of accounts, specific attention should be paid. In determining risks, country risk is a necessary part of the overall risk analysis (FATF, 2008:11).

5.3 REQUIREMENTS FOR IMPLEMENTING AN EFFICIENT RISK BASED APPROACH TO ANTI-MONEY LAUNDERING

Both the regulators and those being regulated may adopt an RBA. Regulated entities have the discretion to decide what they regard as risks and, at the same time, the regulators may decide how they wish implement their RBA, based on known areas of high risk; namely, the probability that a risk will materialise and what the impact of such risk will be. Applying an RBA to AML is referred to as a "double risk assessment" (Unger & Van Waarden, 2009:4, 5).

AML/CFT processes may be enhanced when specific measures are implemented in the development of an RBA. These specific measures may include conducting a national risk assessment in order to ascertain the particular threats that a country is facing, adopting regulatory frameworks in countries that would support an RBA and monitoring the structures of the regulators. In addition, the regulated entities should support the RBA while all parties involved in the RBA to AML/CFT should be identified, with countries ensuring the obligations are shared between these entities in a consistent way (FATF, 2008:15).

In order to ensure the successful implementation of an RBA to AML in any country, the following is required; namely, accurate information with regard to the risk of ML while full disclosure of such information should be made to both the regulators and the regulated entities. Cooperation between all the role players in the AML/CFT measures should be promoted, although with the realisation that an RBA will never succeed in eliminating all risks. Where FI have exercised accurate judgment and adopted appropriate risk management policies and procedures, they should be confident that enforcement actions will not be taken against them. The measures required as regards the adoption of an RBA should be consistent, as well as the RBA to supervision of regulated entities. Accordingly, it is essential that the employees of regulators be well versed in the requirements of an RBA as regards both regulating AML measures and implementing an RBA within a regulated entity (FATF, 2007a:10).

5.4 BENEFITS AND DRAWBACKS OF A RISK BASED APPROACH TO ANTI-MONEY LAUNDERING

There are various benefits to an RBA which a rule-based approach does not offer, namely, both regulators and regulated entities are able to use their resources more efficiently, thus decreasing the burden on clients while, as a result of an enhanced focus on higher risk situations, greater successes are possible. In an ever changing risk environment, an RBA allows for flexibility as regards amending the required risk management policies and procedures (FATF, 2007a:3). Criminals are also kept in the dark if entities follow an RBA to AML as they will not know in advance how risks are determined (Van den Broek, 2011:173).

Despite the fact that an RBA allows entities to use their discretion in assessing risks, as they are most familiar with the risks which they face, this may also lead to confusion as entities do not always define risk in the same manner (Van den Broek, 2011:173).

Another disadvantage of adopting an RBA is that businesses have the discretion to decide when to report a transaction. This may, in turn, result in reporting not being carried out in a responsible manner, with regulators not being placed in possession of crucial information regarding the ML that has occurred. However, the opposite may also be the case should there be an over reporting of transactions by businesses that, for fear of being fined in any enforcement actions, prefer to over report rather to underreport. This, in turn, may result in regulators being inundated with data and having to shoulder the extra burden of processing all the information (Unger & Van Waarden, 2009:6).

In addition, regulated entities often incur extra costs when adopting an RBA as they have to create their own policies and procedures dealing with risk management; these policies and procedures have to be maintained and all the staff members have to be trained in these policies and procedures (Van den Broek, 2011:173). In order to discern real ML risks effectively, regulated entities may also have to employ more expert staff members. Finally, regulated entities may also be challenged by adopting an RBA in view of the uncertainty regarding the way in which regulators may respond to various practices when adopting an RBA (FATF, 2007a:5).

5.5 FOLLOWING A RISK-BASED APPROACH TO POLITICALLY EXPOSED PERSONS

5.5.1 Managing the risks associated with dealing with politically exposed persons

In the interests of implementing an RBA to AML efficiently, it is recommended that FI adopt risk management policies and procedures which aim at effectively minimising the risk of ML occurring within the FI. As an integral aspect of an efficient RBA, these risk management policies and procedures should include creating precise client profiles which will identify categories of specific high risk clients, including clients from foreign jurisdictions and PEPs (FATF, 2007a:16, 17).

Whereas the majority of PEPs probably act with honesty and integrity, there are also those PEPs whose corrupt dealings have placed them in possession of vast sums of money which they would want to inject in the financial systems without any intrusion into their illegal activities. FI have, thus, been referred to as the “first line of defence” in preventing PEPs from committing ML. In this regard it is, therefore, vital that FI are familiar with the concept of PEPs in all their business dealings (De Klerk, 2007:369, 370).

Engaging in business relationships with PEPs poses distinct challenges in view of the high risk of ML poses when dealing with these individuals. The standard CDD for these

individuals has proven to be inadequate and, hence, Recommendation 6 of the FATF 40 + 9 requires that EDD be applied to all PEPs (Choo, 2008:375).

It has been noted that the key motivation as regards being aware of the potential problems involved in engaging with PEPs and the risk associated with conducting business with them is the concomitant threat to reputational risk. It is not possible to quantify reputational risk in the same manner as enforcement penalties may be quantified while the damage to reputation may, in some instances, far exceed the penalties imposed by regulators (De Klerk, 2007:370, 371).

For the purposes of ML, PEPs are considered to be a high risk category of client. This is mainly as a result of their positions of influence which may make them susceptible to their abusing their power and of becoming corrupt by embezzling public funds. In addition, there is the risk associated with PEPs using their family members or close associates to hide the assets they have misappropriated from their governments. PEPs have, in the past, been known to gain control of legal bodies in order to conceal their corruption (MENAFATF, 2008:3).

Recommendation 6 of the FATF 40 + 9 requires that EDD be applied to all PEPs. This, in turn, would imply that the risk management processes in place enable the identification of a PEP, that senior management always approve the establishment of a relationship with such an individual, that the source of wealth and funds of the PEP always be determined and that there be ongoing monitoring of such a relationship (FATF, 2003b:6). It has been suggested that, in order to mitigate the risks associated in dealing with PEPs adequately, financial institutions should have adopted at least two specific policies for the purpose of engaging with PEPs; that both new and existing PEPs be identified, that a proper risk assessment of these clients' accounts be undertaken and a further policy adopted to ensure that authentication will be conducted, in all instances, to ensure that a PEP's funds are legal (De Klerk, 2007:377).

It is important to realise that not all PEPs are corrupt and that it is not the intention of the FATF 40 + 9 to prohibit FI from entering into business relationships with PEPs. However, applying enhanced CDD requirements to PEPs implies that the risk associated with such PEPs be identified and mitigated accordingly. Various factors may determine the level of risks associated with a PEP, including the nationality of a PEP, the PEP's seniority, the complexity and volume of business transactions concluded, specialised products or services offered and the foreign entities involved (MENAFATF, 2008:4, 5).

5.5.2 Measures for applying a risk based approach to PEPs

Applying an RBA to PEPs must commence with the initial CDD, including identifying a client as a PEP, and then proceed to more rigorous and ongoing monitoring of the PEP in question. The FATF 40 + 9 require that, once a client has been identified as a PEP, that client will always be regarded as a high-risk client (Greenberg et al., 2010:43).

The appropriate management of the risks involved in dealing with a PEP may be accomplished by obtaining as much information as possible about the customer, including the customer's country of residence, source of funds, the possibility that the customer may become a PEP, confirming whom the customer's close family members are and also confirming the identity any other persons who may act on behalf of the customer in the business relationship. It is essential that senior management accept its responsibilities with regard to the approval of business relationships with PEPs while the compliance function should constantly assess the adequacy of the PEP controls in the business, including the regular training of all staff members on CDD procedures and the management of business relationships with PEPs (MENAFATF, 2008:6).

PEP risks may be effectively mitigated when an RBA has been appropriately implemented and the flexibility of the RBA makes provision for the various types of PEPs as customers, the foreign jurisdictions in which they may reside, the types of products they may use and any changes in their status quo over a period of time. An RBA to PEPs has proved to be extremely effective as regards managing PEP risks and also allows for resources to be focused where the greatest PEP risks have been identified (Greenberg et al., 2010:24).

Both a universal definition of PEPs and maintaining a list of all known PEPs will not adequately mitigate the risk associated with PEPs. However, applying an RBA will prove to be extremely efficient by enabling regulators and regulated entities to determine which risk management strategies with regard to PEPs would be the most appropriate to their respective country and entity. When conducting their risk analysis it is recommended that regulated entities use their discretion when formulating their risk management policies with regard to PEPs. The factors that may be appropriate to PEPs may include the following, namely, the period for which the PEP monitoring will continue once a PEP has ceased to be a PEP, the positions in respect of which a person would be considered to be a PEP, the way in which "immediate family members" or "close business associates" would be defined

and whether to include domestic PEPs in AML measures (Choo, 2008:373). Merely identifying a PEP does not mean that all the risks associated with PEPs would have been recognised or mitigated. On the contrary, it is essential that all the “risk relevant” information on a PEP be obtained, including any allegations of fraud against such a PEP, whom their close family members are and the business entities on which boards of directors they sit (De Klerk, 2007:378).

When FI operate in jurisdictions that have adopted an RBA, these FI are able to exercise their judgement in deciding whether further groups of persons should be classified as PEPs. Various factors such as the business deal involved, the facility offered and/or the product involved may constitute risk indicators which would then enable the FI to broaden the scope the definition of a PEP (Greenberg et al., 2010:30).

PEPs are not all corrupt and, thus, it has been recommended that a “risk based KYC” procedure to PEPs be followed. Such a procedure may include factors such as identifying both the beneficial owner and the proposed account holder and also their nationalities. Individuals should be required to confirm whether they have PEP status, as well as where they are employed and all sources of their funds. Internationally available information should be researched to confirm the PEP status while relevant references should be consulted to determine this. It is also essential that immediate family members and close associates are identified, the purpose for which the business relationship is being established and the amounts that will move through such an account (Choo, 2008:375,376). As regards PEPs, FI should also conduct an EDD on all the legal entities with which they do business. PEPs have been known to use “corporate structures” in order to hide their true identities. In this regard the Third AMLD has indicated that a legal entity is considered to be a PEP where the beneficial owner is a family member of a PEP (De Klerk, 2007:379).

As regards the efficient implementation of an RBA, regulated entities should not adopt rule-based policies in respect of when a PEP will no longer be considered to be a PEP, but should rather consider the status of each PEP on their own merits. PEPs who are considered to be in a “higher risk” category will continue to be classified as such with the necessary monitoring of their accounts continuing under this auspice (Choo, 2008:373).

The classification of foreign and domestic PEPs has been challenged; that is, a PEP is a PEP is a PEP, whether they live within a jurisdiction or outside thereof. It is inconceivable that a foreign PEP poses a greater risk than a domestic PEP as they are both high risk

clients and, in certain instances, domestic PEPs may even pose greater risks than foreign PEPs. Differentiating in this manner between PEPs may indicate that a FI is not identifying and mitigating its ML risks efficiently (De Klerk, 2007:379). However, the FATFR require that FI should take reasonable measures to determine whether a client or beneficial owner is a PEP or not (FATF, 2012a:16).

It has been recommended that, as part of adopting an RBA to PEPs, FI should review their PEPs on a regular basis, at least once a year. This, in turn, would entail compiling the client profiles of all PEPs, including the transactions they conducted during the year and any changes to their profiles. The PEPs' client profiles would then be analysed by, for example, the audit or compliance department, submitted to senior management for review and then signed off on the FI's PEP list (Greenberg et al., 2010:55).

5.6 SUMMARY

With the application of an RBA to AML, regulators no longer prescribe rules as to what must be reported in terms of ML and regulated entities have the discretion to rate the ML risks in their businesses as either high or low. However, this has led to various definitions and interpretations of ML risks which have caused uncertainty as to the exact requirements involved in adopting an RBA to AML (Unger & Van Waarden, 2009:19).

Despite the fact that the FATF 40 + 9 repeatedly refers to the term "risk based", it does not offer examples of what this term entails, with the result that inefficient risk management structures have been incorporated into regulated entities. FI consider the possibility that enforcement action may be taken against them and, thus, they choose to adopt risk management structures that cover every possible risk, but that rarely lessen the possibility of such risks occurring. In order to ensure the effectiveness of an RBA, it is vital that senior management accept responsibility that its risk management frameworks are "appropriate and proportionate" and that these frameworks must be uniquely adapted to both the risk acceptance and the profile of each entity (Killick & Parody, 2007:211).

The issue of the reputational risk associated with dealing with PEPs has recently received increased attention from FI with, for example, more banks focusing on knowing whom their PEP clients are and monitoring their transactions and profiles on an ongoing basis. In order to deal efficiently with the risks that PEPs pose to regulated entities it is recommended that these regulated entities implement the measures as set out in the FATF's High Level Principles and Procedures Guidance, which require that an RBA be adopted as regards

AML measures. This RBA highlights the importance of risk management systems, CDD, training of staff, ongoing monitoring and randomly auditing an entity's list of clients (Gilligan, 2009:141).

Risk has become a focal point of the AML/CFT framework. There are both advantages and disadvantages to an RBA, as it may prove to be more "efficient and effective" by identifying high risk situations but it should be wary of preventing lawful financial transactions. It has been suggested that an important element of a successful RBA to AML is the necessity of regulators being transparent in respect of what they define as ML risks, as well as the fact that regulated entities should feel confident in disclosing information to regulators (Ross & Hannan, 2007:113, 114).

CHAPTER 6: THE SIGNIFICANCE OF POLITICALLY EXPOSED PERSONS

6.1 THE FOCUS ON POLITICALLY EXPOSED PERSONS

In recent years, the embezzlement of state funds and the corruption committed by both leaders of governments and civil servants has received increased attention. The enormous amounts of money obtained by these individuals were often transferred to foreign jurisdictions and hidden from detection by their being allocated to the accounts of legal structures or close family members and business partners of the individuals concerned (FATF, 2002:12).

One of the earliest cases of such corruption was of Ferdinand Marcos who was the president of the Philippines between 1965 and 1986 (FATF, 2011:48). During his reign it is believed that he embezzled $10 billion from his country (Johnson, 2001:123) He was infamous for bribery, demanding 10% from all government contracts. In addition, he ensured that the economic aid from Japan and the United States to the Philippines was diverted into his personal accounts. He plundered government coffers by taking funds from both the treasury and the country's gold reserves. The protracted period of his reign in the Philippines enabled him to embezzle large amounts of money from the country (Chaikin, 2000:5, 6).

An increased awareness of the links between corruption and ML have led to various initiatives to curtail these crimes, and it was anticipated that these efforts would assist the developing countries to recover the funds stolen by their political leaders (Johnson, 2008a:291). **I**n 2001, the Basel Committee on Banking Supervision issued requirements for CDD which were applicable to banks and also provided details of the way in which to deal with PEPs (Basel, 2001:10). The FATF also recognised the link between ML and corruption and deemed it necessary to classify PEPs in the revision of its Recommendations. Thus, the FATF 40 + 9, published in 2003, contained a new recommendation (Recommendation 6), which specifically set out the EDD applicable to PEPS (Johnson, 2008a:292).

FI will be able to manage the risk of ML effectively if they are familiar with the ML risks that their clients and their dealings pose to the business (Wolfsberg Group, 2008:1). PEPs are regarded as high risk customers for ML purposes as there is a possibility that these individuals may abuse their power in order to commit corruption and also to influence organisations in order to commit corruption (Choo, 2008:372). Business associates and

close family members have also been used by PEPs to hide the assets they have embezzled from their countries (Wolfsberg Group, 2008:1).

6.2 DEFINING A POLITICALLY EXPOSED PERSON

There is currently no international and unanimously established definition of a PEP. The FATF, EU, JMLSG and the Wolfsberg Group have all adopted their own definitions of what a PEP is, with these definitions ranging between a broader and a narrower approach to the problem of deciding when an individual may be considered to be a PEP (Choo, 2008:372).

In terms of the UNCAC, it is a requirement that all parties to the convention should perform EDD in respect of both current and new business relationships entered into with persons who hold, or have held, prominent public positions. This EDD requirement is also applicable to the family members and close associates of such persons (UNODC, 2004:42).

The FATF 40 + 9 defines PEPs as natural persons who currently occupy or have in the past occupied very senior public positions in foreign jurisdictions. In its glossary, the FATF 40 + 9 provides examples of such persons with these persons including presidents of countries, persons who hold senior positions in political parties, senior office holders in all government departments and senior managers in entities owned by governments. Family members and close associates of PEPs are also regarded as high risk customers (FATF, 2003b:17).

The EU defines PEPs as natural individuals who are or have been assigned to “prominent public functions”. Included in this definition are the close family members and close business partners of such individuals (European Union, 2005: L309/22).

In the United Kingdom the term PEP refers to a natural person in a country outside of the United Kingdom and who occupies or had held a “prominent public function” in the previous year. The term includes a reference to their near family members and close associates (JMLSG, 2011:162).

The Wolfsberg Group definition of a PEP proceeds to further include members of a royal family, judges and the officers in charge of international organisations such as the World Bank, IMF and UN (Wolfsberg Group, 2008:2). In South Africa, the FIC refers to a PEP as a natural person who currently, or in the past, has been assigned to a prominent public position in a specific country. The definition makes no distinction between foreign and

domestic PEPs. The Wolfsberg Group principles have been accepted as the most recognised procedure to follow with regard to PEP regulation (FIC, 2005:25).

Including family members in the definition of a PEP is extremely relevant as was demonstrated in the case of President Chen of Taiwan whose wife was prosecuted for corruption and cases of counterfeiting, while his son-in-law was also charged for insider trading (Johnson, 2008a:293). In 1998, after the demise of Abacha, president of Nigeria, 38 pieces of luggage, all containing cash, were discovered to be in the possession of his wife at Lagos airport, while it was also discovered that his son was in possession of $100 million in cash (FATF, 2011:25).

In the investigation into the Riggs Bank's dealings with PEPs it was found that the bank had assisted the President of Equatorial Guinea and his wife by accepting cash deposits of almost $13 million into accounts controlled by the President and his wife (United States Senate, Permanent Subcommittee on Investigations [US], 2004:3). Omar Bongo, President of Gabon, abused his diplomatic status and managed to provide his daughter, who was a student in the United States, with large amounts of cash. In one instance a bank discovered that she had held $1 million in $100 bills in her safe deposit box. It appeared that her father had not declared this cash when he had entered the United States (United States Senate, Permanent Subcommittee on Investigations [US], 2010:3).

The validity of the definition of PEPs as including close associates was confirmed in the matter of Vladimir Montesinos, presidential advisor in Peru from 1990 to 2000 (FATF, 2011:47). Through the use of associates, Montesinos was able to embezzle money from the pension funds of both the police and the army and to acquire a majority interest in a Peruvian bank. His ownership of the bank then provided him with a conduit for the proceeds of his corrupt activities (ADB/OECD, 2007:194).

The FATFR now include definitions for foreign and domestic PEPs with foreign PEPs being defined as natural persons who currently occupy, or have in the past, occupied "prominent public functions" while domestic PEPs refer to natural persons in similar positions as indicated for foreign PEPs, but employed in such positions locally. The senior management of international organisations has also now been included in the definition of PEPs (FATF, 2012a:118,119). As in the FATF 40 + 9, the FATFR also require EDD for foreign PEPs. In cases in which a FI has identified either a domestic PEP or a person in senior management at an international organisation, and only if the FI regards the business relationship with such a person as posing a higher risk than what is considered the norm, should EDD be

applied to such a person. The FATFR definition of PEPs continues to include family members and close business partners of the person concerned (FATF, 2012a:16).

The fact that the FATF 40 + 9 limits PEPs to foreign PEPs only, has been the cause of numerous discussions, including whether this is the correct approach and whether EDD should also apply to domestic PEPs (Gilligan, 2009:139). A vital flaw in the FATF 40 + 9 is the fact that EDD applies to foreign PEPs only. Thus, corrupt regimes often ensure that legislation does not include domestic PEPs and this enables corrupt PEPs to place the funds which they embezzle into FI in their own jurisdictions (Chaikin, 2010:2).

The UNCAC does not differentiate between foreign PEPs and domestic PEPs (UNODC, 2004:42). Thus, where countries have ratified the UNCAC, it stands to reason that their PEP frameworks will reflect that no such distinction exists. To date Singapore and Mexico only have adopted this approach (Chaikin 2010:2).

It has been suggested that countries should deal with corruption in their own jurisdictions before attempting to apply EDD to foreign PEPs and international attempts to regulate PEPs will be futile if countries are unable to deal with the corruption in their own governments (Johnson, 2008a:300).

It has become apparent that an internationally accepted definition of a PEP is required and that the absence of such a definition has hindered the proper application and enforcement of compliance with PEP regulation by all parties concern (Greenberg et al., 2010:25).

6.3 PEPS AND MONEY LAUNDERING

ML involving wealthy persons who occupy prominent public positions, or have previously occupied such positions, has gained much attention lately with these PEPs having acquired their riches through corruption. This leads to the conclusion that ML may cause corruption (Choo, 2008:372).

In 2004, Transparency International, the anticorruption watchdog, published details on PEPs who had embezzled the most funds over a period of two decades. These include the following:

- the erstwhile president of Indonesia, Suharto ($15–35 billion)
- Marcos, former president of the Philippines ($5–10 billion)
- Sese Seko, one time president of Zaire ($5 billion)

- Abacha, former president of Nigeria ($2–5 billion)
- Milosevic, past president of Serbia/Yugoslavia ($1 billion)
- Jean-Claude Duvalier, a former Haitian president ($300–800 million)
- Fujimori, former president of Peru ($600 million)
- Lazarenko, erstwhile prime minister of the Ukraine ($114–200 million)
- Alemán, a previous president of Nicaragua ($100 million)
- Estrada, a past president of the Philippines ($78–80 million) (Transparency International, 2005:13).

The various methods which PEPs employ to launder the earnings of their corruption have been identified with instances of corruption on a large scale, including bribery, self-dealing, conflicts of interests, blackmail and misappropriation of a country's assets appearing to be the most popular methods used by corrupt PEPs (FATF, 2011:16).

There are certain inherent risks in having a PEP as a client and, if these risks are not managed adequately, this may lead to the demise of the FI in question. The fact that Riggs Bank had not only failed to manage the risks associated with having PEPs as clients, but its senior management had assisted these PEPs to hide the proceeds of their crimes, led ultimately to the bank's downfall (Johnston & Carrington, 2006:53). Riggs Bank aimed to be the bank of choice for embassies and diplomats and, in about 1950, it succeeded in acquiring the majority of the embassies in Washington as its clients (De Klerk, 2007:370). Unfortunately, this ambition led to Riggs Bank entering into business transactions with various dictatorial regimes, with customers in the Riggs database including Mbasogo from Equatorial Guinea and Pinochet from Chile. There were also accusations that Riggs Bank had facilitated the transfer of funds from Saudi Arabia to two of the 9/11 hijackers (Oduor, 2010:2).

It was reported that Riggs Bank had attended to the administration of Pinochet's illicitly acquired money when the Spanish court had decreed that all his funds should be frozen. Riggs Bank had opened various accounts for Pinochet without confirming the source of the money. Riggs also created offshore shell companies and used Pinochet's family members and officials in the military to hide the fact that he was the ultimate beneficial owner of these funds (Johnston & Carrington, 2006:53).

Obiang, son of the president of Equatorial Guinea, reportedly earned $4 000 a month as a minister of the country but owned a mansion in Malibu worth $35 million (Global Witness, 2009b:8). A senior bank manager at Riggs facilitated the deposit of $3 million cash into one of Obiang's offshore shell accounts, but without the requisite due diligence expected of an established bank. Various others of Obiang's unidentified companies also received $35 million specifically in countries with bank secrecy laws. Both the chairman and the CEO of Riggs officially declared their appreciation of Obiang's patronage (Oduor, 2010:7).

Although Riggs Bank may have closed down after an investigation into its inefficient AML measures and its accepting Equatorial Guinea's money from oil, various other unidentified commercial banks still keep some of these oil funds. There has been no disclosure regarding the location of these banks and the use of these funds. It is estimated that, in Riggs's time, these funds amounted to $700 million but they have, in the interim, increased to an amount in excess of $2 billion (Global Witness, 2009b:8).

Corrupt PEPs have been notorious for accepting bribes, with the proceeds of these bribes passing through shell corporations or trusts of which the PEP is the beneficial owner. These proceeds of corruption may, possibly, never enter the financial system of the country from which the PEP originates. In other instances the proceeds from the bribes remain in the PEP's home country, for example, in the case of Estrada, the president of the Philippines. He was notorious for receiving bribes from gambling companies on the understanding that these gambling companies would be able to operate without any interference from the legal system. These funds were allocated either to the accounts of legal entities of which Estrada was the beneficial owner or into the accounts of fabricated persons (FATF, 2011:16).

Self-dealing is another way in which corrupt PEPs have enriched themselves. Theodorin Obiang, son of president Obiang of Equatorial Guinea, was discovered to be the owner of an important forestry company in his country. The company had the exclusive rights to export timber from his country (US, 2010:20).

ML is easily facilitated in instances in which a corrupt and despotic PEP has total control of all government departments, including the regulators, the judicial system and the law enforcement functions. Where such total control of all government functions exists, a corrupt PEP is able to hide and move the proceeds of his/her corruption without any interference (FATF, 2011:26). Pavel Lazarenko was the Prime Minister of the Ukraine for a period of 15 months only during 1996 and 1997, but he was able to embezzle more than $300 million from the country (FATF, 2012b:15). Such was Lazarenko's control over the

Ukraine that all the entities that conducted business in the country had to provide him with half of all their profits. The proceeds of natural gas bought by clients were also diverted to offshore shell companies of which he was the beneficial owner (FATF, 2011:27).

It has been estimated that, during his reign, Sani Abacha embezzled $4 billion from the Nigerian treasury (De Klerk, 2007:369). Abacha possessed such absolute power in Nigeria that he was able to authorise his national security advisor to generate and submit fabricated requests for funding, which Abacha then approved. This cash from the country's central bank was then laundered through local FI and businessmen in Nigeria and in foreign countries. The embezzled funds were diverted into the accounts of Abacha's close family members (FATF, 2011:27). Both these instances of grand corruption were facilitated by the autocratic powers possessed by these leaders which enabled them to control the authorities entrusted with the prevention and detection of ML (FATF, 2012b:10).

Gatekeepers have been identified as playing a complicit role in assisting PEPs to launder the proceeds of their corruption (FATF, 2010:45). Theodorin Obiang's attorney in the United States, Berger, used three banks in the country to bring the embezzled funds into the United States via shell corporations, attorney client accounts and other accounts. He even resorted to setting up a PayPal account for Obiang's excessive purchase requirements (US, 2010:45).

A United States bank assisted Raul Salinas, brother of the president of Mexico, to transfer $76 million from Mexico to the United States and then on to the United Kingdom and Switzerland. An official of the bank used the bank's concentration account, which served as a suspense account before funds were allocated to their correct accounts, to transfer money to Salinas's accounts in the United Kingdom and Switzerland and, in this way, the link between Salinas and these funds was successfully hidden (FATF, 2012b:38).

6.4 SOLUTIONS FOR DEALING WITH POLITICALLY EXPOSED PERSONS

International adherence to PEP requirements is dismal. During an analysis conducted by the FATF and FSRB of 124 countries, it was noted that 61% of these countries were non-compliant with FATF PEP requirements, while 23% only were compliant to some extent (Greenberg et al., 2010: xv). Typical warning signs that a PEP may be corrupt include PEPs possessing wealth that is inconsistent with their known earnings, transactions being concluded that do not correspond with the clients' usual business dealings, and an inability to determine the beneficial owners of complicated legal entities (Choo, 2008:377).

Determining the net worth of PEPs has been recommended as a solution to determining whether such a PEP has obtained his/her wealth in a corrupt way. During a PEP's tenure in public office, his net worth should grow in accordance with his savings and capital appreciation only. Thus, a net worth that has grown more than may be reasonably expected is suspicious and, in fact, in Hong Kong and in India, this would be regarded as prima facie proof of a crime (Chaikin, 2000:7).

If an FI is to manage PEPs efficiently as part of its client base, it is essential that the risk management procedures include the following: senior management approval for engaging with a PEP once a new client has been identified as having PEP status, systems to identify when an existing client becomes a PEP, conducting EDD on PEPs and the origin of their wealth as well as incorporating the ongoing monitoring of PEP accounts both in terms of transactions concluded and the accuracy of the PEPs' risk profiles. In addition, the staff members of the FI must undergo regular AML training that will assist them to identify PEPs and also the risk they pose to the FI (Wolfsberg Group, 2008:5, 6).

In order to create a culture in which PEP principles are adhered to, it has been recommended that three vital functions be adopted and maintained, namely, there will have to be the political will to deal with this issue, international PEP regulation should be explained and coordinated in such a manner that all affected entities clearly understand what is required of them and case studies of PEPs should be used to assist with the ultimate identification of the beneficial owners who are PEPs (Greenberg et al., 2010: xv).

The processes for dealing with PEPs may be enhanced if the following practices are incorporated into a FI's overall PEP management regime; namely, EDD must be applied to the local PEPs in a country and should not be limited to PEPs residing in foreign jurisdictions, all clients should be required to declare whom the beneficial owner is of the business transaction in question, civil servants must be required to disclose the assets and sources of income as disclosed when they took up office, an annual review should be undertaken of all the PEPs in a FI's client base and regulatory frameworks should avoid adopting a rule based approach once a PEP has ceased to be classified as such (Greenberg et al., 2010: xvi, xvii).

The employment of efficient AML measures on an international level will mean that corrupt PEPs will be brought to task, even where their own countries have been unable to do so (Chaikin, 2010:1). Developing countries have been severely affected by corrupt regimes and this, in turn, has motivated the improvement of AML measures, both nationally and

globally. In this regard frameworks have been developed in terms of which these illicitly gained funds are frozen and then returned to the countries from which they were stolen (Campos & Pradhan, 2007:391). An example of the successful execution of this procedure involved the case of a Geneva magistrate who froze the $84 million held in the accounts of offshore companies of which Kazakh officials were the beneficial owners. The highest court in Switzerland found these funds to have been gained illicitly and returned them to Kazakhstan for the development of the country (Chaikin, 2010:3).

A further measure as regards the effective management of the risks that PEPs pose to FI is to monitor current PEPs and persons who may have become a PEP on an ongoing basis after they have entered into a business transaction with an FI (Choo, 2008:376). Implementing EDD to its PEPs, specifically with reference to family members and close associates of PEPs, may pose a challenge to the FI concerned. The changing political environment within a country may lead to a host of new persons becoming PEPs, in addition to those persons who would have become PEPs after marriage (MENAFATF, 2008:5).

In the majority of instances PEPs do not occupy public office for a protracted period of time and this creates a challenge for FI as regards when to stop classifying a customer as a PEP. The FATF 40 + 9 do not stipulate specific periods of time for which a person should continue to have PEP status after leaving office. However, in view of the FATF requirements for adopting an RBA to AML measures, it is recommended that FI should also apply this principle to the ongoing monitoring of their PEPs and to deciding when such a customer will no longer be classified as such (Greenberg et al., 2010:31).

Various investigations conducted by the US and Switzerland into the dealings of foreign PEPs have created an awareness that countries should progressively expand their AML frameworks. Until such a time that all countries have adopted similarly stringent AML frameworks, variances in AML frameworks will enable corrupt PEPS to launder the proceeds of their crimes (Chaikin, 2010:5).

6.5 SUMMARY

In recent decades there has been an increased international focus on PEPs and the manner in which they are able to embezzle huge amounts of money from their countries, which they then successfully launder through domestic and international financial systems. This corruption on a grand scale has impoverished several countries and severely curtailed

their developmental prospects (Greenberg et al., 2010: XIII). PEPS are regarded as high-risk customers for FI and may represent substantial financial, reputational and legal risk to entities that have such persons as their customers (MENAFATF, 2008:4).

Despite the fact that various definitions of PEPs exist, it has been a challenge to find an internationally accepted definition of a PEP (Gilligan, 2009:137).

A definite link between corruption and ML has been established, as well as the involvement of PEPs in such corruption and ML. Various investigations have revealed that PEPs have laundered the illicit funds obtained from the embezzlement of government treasuries, bribes, fraud and even from drug trafficking and organised crime (FATF, 2004a:19). PEPs have evolved in the manner in which they launder the proceeds of their corruption. Where PEPs may, in the past, have placed the funds into their own names or those of their family members, they have advanced to more sophisticated measures such as using their attorneys and shell corporations to host their illegal funds. PEPs have also resorted to transferring their illicitly gained funds to foreign jurisdictions and acquiring assets in these jurisdictions (Geary, 2010:104).

Compliance with the FATF 40 + 9 requirements on dealing with PEPs is extremely poor and it would appear that there is no political will to deal with the threats that PEPs may pose. This lack of resolve in dealing with PEPS as required by the FATF is enabling corrupt PEPs to have access to financial frameworks, even where such frameworks are well regulated. As part of the overall lack of compliance with the FATF PEP recommendations, the absence of ongoing PEP monitoring allows these corrupt PEPs free choice regarding where to integrate their funds in the international financial systems (Johnson, 2008a:298).

Countries will be able to combat corruption successfully if they improve their AML frameworks with well-developed, global AML frameworks enabling the successful prosecution of foreign PEPs and the confiscation of their illegal funds for return to the country from which they originated (Chaikin, 2010: 6).

CHAPTER 7 AN ANALYSIS OF ANTI-MONEY LAUNDERING REGULATORY FRAMEWORKS RELEVANT TO POLITICALLY EXPOSED PERSONS

7.1 INTRODUCTION

The link between money laundering and corruption has compelled the FATF to include measures on PEPs in its FATF 40 + 9 (Johnson, 2008:292) with the aim of ensuring that higher risk customers would be identified and also to make certain that the more efficient monitoring of their transactions would be undertaken (Greenberg et al., 2010:4).

The Third AMLD, together with its Implementing Directive, which has specific application to EU Member States, created a definitive framework for PEPs with the legal PEP framework being based on the FATF 40 + 9 (Greenberg et al., 2010:19).

The FATF Mutual Evaluation Report of the United Kingdom, which was conducted in 2007, indicated that there were no enforceable duties with regard to PEPs in the United Kingdom and, therefore, the report rated the United Kingdom as non-compliant with Recommendation 6 of the FATF 40 + 9 (FATF, 2007b:128). The United Kingdom subsequently published its MLR in 2007, which replaced the 2003 version, so as to include the Third AMLD. The MLR contains specific requirements relating to, among other things, PEPs (FATF, 2009:5).

In South Africa, in addition to the FICA and its regulations, the FIC issues Guidance Notes. However, these Guidance Notes are issued for information purposes only and, although described by the FIC as authoritative, they are not regarded as the “other enforceable means”, as described by the FATF (FATF/ESAAMLG, SA, 2009:88). Apart from Guidance Note 3, the South African AML regulatory framework contains no “enforceable obligation” in respect of any accountable institution to determine whether or not a customer is a PEP. This is in stark contrast to the FATF that determines that PEPs are to be considered as of substantial consequence as they are continuously to be regarded as high-risk clients for the purposes of ML (FATF/ESAAMLG, SA, 2009:98). It is unclear whether Guidance Note 3 must be regarded as compulsory or merely as best practice for banks to consider when dealing with PEPs (FATF/ESAAMLG, SA, 2009:92).

Various factors relating to PEPs have been identified and are relevant when a business relationship with such a person is established. These factors are discussed below by

comparing the approaches adopted by the various regulatory frameworks relevant to politically exposed persons.

7.2 DEFINING POLITICALLY EXPOSED PERSONS: FOREIGN AND DOMESTIC

7.2.1 The Financial Action Task Force

The FATF 40 + 9 define PEPS as persons who are, or have in the past, "been entrusted with prominent public functions in a foreign country". Family members of PEPs as well as their close associates are also included in this definition as they have been indicated to represent reputational risks akin to those represented by PEPs. However, this definition has excluded PEPs who occupy middle and junior positions in public service (FATF, 2003b:17). However, the interpretive notes to the FATF 40 + 9 indicate that countries are encouraged to apply EDD to domestic PEPs (FATF, 2003b:22).

The FATFR has extended the definition of PEPs where, as in the FATF 40 + 9, it refers to foreign PEPs with examples of such persons including the leaders of countries, persons employed in senior government positions, executives of entities that are owned by governments and significant officials of political parties. The FATFR now also includes a reference to domestic PEPs as persons occupying positions as mentioned above, but in their own countries. Included in the definition of PEPS are persons occupying board or senior management positions in international organisations (FATF, 2012a:118, 119).

7.2.2 The Third Anti-Money Laundering Directive

The Third AMLD defines a PEP as a natural person who currently is occupying, or has in the past occupied, a prominent public position. In this definition is included the immediate family members of PEPs and also individuals who are close associates of these persons (European Union, 2005: L309/22). It is significant that the Third AMLD's definition of a PEP is regarded as the best established definition of such persons, while it is also more detailed than the FATF definition of a PEP. This is specifically as a result of the fact that the Third AMLD's definition provides for legal persons who are associated with PEPs, in addition to the beneficial ownership and control of legal entities by persons who are PEPs (APG/FATF, 2007:34).

In 2006, the European Commission issued an Implementing Measures Directive that includes and expansion and recommendations for implementing the definition of a PEP (European Union, 2006:L214/29). Article 2 of this Directive indicates that the term "PEP"

should include the heads of countries as well as their ministers and deputy ministers. It should also include all members of parliaments, members of supreme courts or high-level judicial entities whose decisions cannot be further appealed, members of courts or auditors or boards of central banks, ambassadors, senior army officials and members of state owned enterprises who function in an administrative, management or supervisory capacity. The abovementioned categories of persons do not include middle or junior persons in these positions (European Union, 2006:L214/31).

There is no distinction in the Third AMLD between a domestic and foreign PEP while EDD is required for all PEPs who live outside of the EU (FATF, 2011:21). In addition, EDD is to be applied to PEPs also residing in other member state of the EU (European Commission [EC], 2012:7).

Despite the fact that the Third AMLD provides a list of who may be regarded as PEPs, there is, nevertheless, a deficiency in that it does not provide for “senior officials of the major political parties”. In all countries, the corrupt ways in which political parties have resorted to raising funds have been identified as a serious flaw in their democracies while, in both France and Germany, cases have been identified in which political parties were embroiled in funding activities that involved corruption and ML (APG/FATF, 2007:44).

The Commission of the European Parliament and Council was requested to submit a report on the application of the Third AMLD as well as the FATFR (EC, 2012:2). This Commission made important recommendations on the way in which the FATFR could be incorporated into the Third AMLD with regard to PEPs. It has been recommended that the definition of a PEP should be expanded to include a domestic PEP and also the senior management of international organisations. In addition, it has been suggested that the requirements of residence be removed from the Third AMLD and that the Third AMLD include the provisions to determine whether a PEP is the beneficiary of a life insurance policy. The Commission has also recommended that, in lieu of applying a fixed term for which a PEP will no longer be considered to be a PEP, institutions should adopt an RBA in deciding when the EDD requirements applicable to PEPs should cease to be relevant (EC, 2012:8).

7.2.3 The United Kingdom

The MLR defines a PEP in Regulation 14(5) thereof as a person who, in the past year, has occupied a prominent public function in a country other than the United Kingdom and in a community institution or an international body. Immediate family members and close

associates of such a PEP are included in the definition of a PEP. In determining whether a person is a PEP or a close associate of a PEP, consideration must be given only to information which a person possesses or which is publicly known (MLR, 2007:16, 17). Although the definition refers to foreign PEPS, the FSA advises that domestic PEPs should undergo EDD where it would appear that such person poses a high ML risk as contained in terms of the MLR (FSA, 2011b:19).

7.2.4 South Africa

In 2005 the FIC issued Guidance Note 3, entitled "Guidance for banks on customer identification and verification and related matters" (FIC, 2005:2). In the preamble to the Guidance Note, the FIC specifically indicates that applies only to banks, mutual banks, the Post Bank and the Ithala Development Finance Corporation Limited. It proceeds to clarify that the purpose of the Guidance Note is to assist these banks with the practical application of the FICA in respect of client identification and verification requirements (FICA, 2005:6).

Guidance Note 3 defines a PEP as a person who currently, or in the past, has "been entrusted with a prominent public function in a particular country". It proceeds to indicate that the Wolfsberg Group's principles on PEPs should serve as best banking practice guidance for accountable institutions to which this guidance note applies (FICA, 2005:28). The Guidance Note does not provide a definition of "prominent public function", which it adopted from the FATF in lieu of the Wolfsberg Group reference to "important public functions". It has been noted that the use of the word "prominent" may be problematic as various FI may have different interpretations of who would qualify as a PEP (De Klerk, 2007:381).

The Guidance Note proceeds to indicate that the Wolfsberg Group's principles include both domestic and foreign PEPs (FICA, 2005:28). The reference to the term "particular country" ensures that banks do not have to differentiate between foreign and domestic PEPs when engaging with clients (De Klerk, 2007:381).

In order to assist banks in identifying who may qualify as a PEP, the Guidance Note provides some examples of such persons, including heads of governments and countries as well as their cabinet ministers. Senior managers in government departments and state owned corporations, senior judges, senior official of political parties, senior officials of the military and senior officials in international organisations have also been included in the list

while royal families and leaders of religious organisations are included in the definition of PEPs (FICA, 2005:29).

7.3 FAMILY AND ASSOCIATES OF POLITICALLY EXPOSED PERSONS

7.3.1 The Financial Action Task Force

The FATF 40 + 9 has indicated that, when engaging in a business relationship with family members or close associates of PEPs , there are reputational risks akin to when a PEP is accepted as a client (FATF, 2003b:17). The FATF 40 + 9 has not defined what is understood by the terms family members and close associates, and neither does it place any restrictions on the closeness of the family members (Greenberg et al., 2010:28).

7.3.2 The Third Anti-Money Laundering Directive

The Third AMLD limits family members to immediate family members although this has been criticised as not being relevant to certain cultures in which extended family members have relationships that are as close as those of immediate family members (Greenberg et al., 2010:28). The Implementing Directive indicates that immediate family members include a spouse, life partner, children as well as their spouses, and the parents of such a PEP. Persons known to be close associates include those persons who are known to have joint beneficial ownership of legal entities, or any other close business relationship, with such a PEP. The Implementing Directive also includes any individual who acts a sole beneficial owner of a legal entity or legal arrangement, which has been created for the de facto benefit of a PEP (European Union, 2006:L214/31, 32).

7.3.3 The United Kingdom

The MLR indicates that immediate family members of PEPs are included in the term PEP and that these immediate family members include spouse, partner, children and their spouses or partners as well as the parents of a PEP. Known close associates are also included in the definition of a PEP with known close associates including persons who have close business relationships with a PEP, or have joint beneficial ownership of a legal arrangement or legal entity. Where a legal entity or legal arrangement has been created for the benefit of a PEP, a person who is the sole beneficial owner of such a structure will also be regarded as a close associate (MLR, 2007:42).

7.3.4 South Africa

As is also incorporated in the Wolfsberg Group principles, Guidance Note 3, issued by FIC, indicates that close family members as well as closely associated persons of PEPs, including close the business associates, advisers and consultants of PEPs, should be afforded distinct scrutiny by banks. The term family includes parents, spouses, children, brothers and sisters and may also include family members who are related by marriage and other family members (FIC, 2005:29).

7.4 ENHANCED DUE DILIGENCE REQUIREMENTS IN RESPECT OF POLITICALLY EXPOSED PERSONS

7.4.1 The Financial Action Task Force

In terms of a fundamental principle of the FATF standards FI should be familiar with their customers so as to ensure that they are not, unknowingly, involved in aiding the ML process (Chaikin, 2010:4). The FATF 40 + 9 requires that FI conduct CDD on their customers and that they should also conduct EDD on PEPS. Recommendation 6 of the FATF 40 + 9 requires that FI should be able to, in accordance with their risk management procedures, determine which off their customers are PEPs. Senior management approval is then required before a business relationship is established with such a PEP and, hereafter, the source of wealth and funds of such a PEP must be determined whilst enhanced ongoing monitoring of the business relationship must be performed on an ongoing basis (FATF, 2003b:5,6).

Recommendation 12 of the FATFR contains similar EDD requirements for foreign PEPs, as set out in Recommendation 6 of the FATF 40 + 9, but proceeds to indicate that FI should confirm whether a customer is a domestic PEP or is currently serving, or has in the past served, in a senior capacity with an international organisation. EDD is then to be applied to such individuals where business relationships with them are regarded as high risk. The EDD requirements also stipulate senior management approval for the establishment of a business relationship, that the source of funds must be determined and that there be enhanced monitoring of the business relationship with such a PEP on an ongoing basis. The FATFR on EDD of PEPS also applies to the family member and close business partners of PEPs (FATF, 2012a:16).

The FATF 40 + 9 recommendation on PEPs has been criticised as being flawed in that it provides for EDD to foreign PEPs only. As a result corrupt regimes have been able to adopt

AML frameworks that intentionally ignore domestic PEPs. This, in turn, has enabled these corrupt PEPs to inject their illegally gained funds with relative ease into their financial systems, thereby concluding the first step in ML, namely, placement (Chaikin, 2010:4).

7.4.2 The Third Anti-Money Laundering Directive

The Third AMLD requires that EDD be applied only to PEPs living in a foreign country and that the requirements apply for a period of one year only after a PEP has ceased to function as a PEP (Greenberg et al., 2010:19).

The Third AMLD does not make a distinction between a domestic and foreign PEP with EDD being required for all PEPs who live outside of the EU (FATF, 2011:21). EDD must also be applied to PEPs living in another Member State of the EU (EC, 2012:7). Accordingly, if a PEP, even a foreign PEP, were to live within the EU, no EDD would be required for such an individual, despite the fact that such a person may have been "entrusted with a prominent public function in a foreign country". Thus, in this regard, the THIRD AMLD does not embody the requirement of the FATF 40 + 9 Recommendation 6, which requires EDD on a foreign PEP, irrespective of where such a PEP may be residing (Greenberg et al., 2010:26). The EDD requirements which are applicable to foreign PEPs have, to date, not been expanded to include the domestic PEPs in any of the Member States. However, in terms of the Third AMLD's stance of applying an RBA to AML measures, it is conceivable that a domestic PEP may be subjected to EDD by an institution if it so deems fit (EC, 2009:88).

The Third AMLD requires that institutions apply EDD measures to customers who are regarded as high risk for the purposes of ML (European Union, 2005: L309/25). Thus, it is incumbent on institutions and persons to which the Third AMLD applies to apply the following EDD measures to PEPs, namely, risk based procedures that will identify when a person is a PEP, senior management must approve the establishment of a business relationship with such a PEP, the source of the wealth or funds to be used for the business relationship must be ascertained and the business relationship must be subjected to ongoing and enhanced monitoring (European Union, 2005: L309/25).

The challenges with regard to EDD, which are applicable to PEPs in the EU, may be addressed by incorporating a standard beneficial owner's declaration form, the registers of PEPs should be improved, legal entities should be forbidden from operating in cases in

which the beneficial owner has not been registered and all legal entities should be required to be subject to enhanced transparency requirements (EC, 2009:282).

7.4.3 The United Kingdom

The FSA has recommended that, despite the fact that EDD does not apply to corporate clients that have a PEP as the beneficial owner, it is required that the usual CDD be applied to determine whether the beneficial owner of the corporate client poses a higher ML risk. Where a high risk has been identified, EDD should be applied (FSA, 2011b:19).

The EDD measures that must be applied when a business relationship with a PEP is being considered or even when intermittent transactions are to be concluded with such a PEP include the following: that senior management approval always be obtained prior to establishing such a relationship, the source of wealth to be used for the transaction must be determined and, once entered into, enhanced ongoing monitoring of such a relationship must take place (MLR, 2007:16).

Where companies that are regulated in the United Kingdom and that fall under its AML regulatory framework either have offices that operate internationally or have subsidiaries that operate there, these companies have the discretion to apply EDD to former PEPs. This becomes extremely important in regions which are noted for their high levels of corruption and ML (Choo, 2008:378).

7.4.4 South Africa

In South Africa PEPs and persons acting on their behalf should undergo “proper due diligence”, with KYC requirements being applied to all PEPs, their family members and their close associates (FIC, 2005:29).

EDD that must be applied to PEPs include the banks employing efficient risk management systems in order to determine whether a client, potential client or beneficial owner is a PEP. Senior management approval is always required for either establishing or continuing a relationship with a PEP, reasonable steps must be taken to establish the source of wealth and funds of the client and also in cases in which the beneficial owner is a PEP. Banks are required to maintain the enhanced monitoring of their relationships with PEPs (FIC, 2005:29, 30).

Banks are also required to include PEPs in both their risk management policies and in their group ML control policies. In addition, they are required to classify all PEPS as high risk clients to whom EDD should always be applied (FIC, 2005:30).

There are four indicators that must be employed to assist with identifying PEPs, namely, at the account opening stage a person should indicate if he/she is involved in any political functions, customer services should be specialised so that employees become familiar with the political environments of specific countries, all employees should undergo regular KYC training that includes PEP provisions and the use of lists of PEPs issued on a commercial basis is advised (FICA, 2005:31).

Both the FATF and ESAAMLG undertook a mutual evaluation of South Africa and found South Africa to be non-compliant with the FATF 40 + 9 requirements in respect of PEPs (FATF/ESAAMLG SA, 2009:216). In this mutual evaluation report, the FATF and ESAAMLG recommended that the South African AML regulatory framework be amended to place a “primary obligation” on all accountable institutions with regard to the identification of PEPs and applying EDD measures to these individuals (FATF/ESAAMLG SA, 2009:226).

7.5 APPLYING A RISK BASED APPROACH TO POLITICALLY EXPOSED PERSONS

7.5.1 The Financial Action Task Force

FI must lay down measures in order to determine the possible ML risk that they face as this will enable them to implement an RBA to ML successfully. These measures will allow FI to identify, inter alia, whether certain customers pose a higher risk of ML, so that these risks may then be mitigated accordingly by the application of proportionate measures. Where the risk assessment of a client has been conducted with the establishment of the relationship, a client’s transaction norms thereafter may require that such a client’s risk profile be amended. This, in turn, would necessitate the ongoing monitoring of the client’s account. It is also conceivable that, based on information received from a competent authority, the FI may have to amend the client’s risk profile after it had established such a business relationship (FATF, 2007a:22). In devising their risk frameworks, it is essential that FI are able to determine the ML risk that a certain type of client may pose to their business. PEPs are regarded as a category of client whose transactions may pose a high risk of ML (FATF, 2007a:23, 24).

In applying an RBA, FI must apply CDD to their clients in order to determine the identity of such clients, identify any beneficial owners and obtain information on the clients’ business

dealings and the type of transactions that the clients are likely to undertake. Various risk levels are considered in the requisite CDD process, for example, low risk clients, compared to the EDD that is required when a client has been identified as a PEP (FATF, 2007a:26).

In the FATF Methodology Paper, it is required that FI, in accordance with their risk management systems, identify whether a new or existing client is a PEP, and whether the beneficial owner of such a client is a PEP (FATF, 2004b:19) The motivation for including PEPs in the FATF 40 + 9 was to ensure that FI realise when they are dealing with PEPs so that they are able to make informed decisions regarding whether or not to engage in business dealings with them. This, in turn, will ensure that FI do not become involved in the ML of illegally gained funds and also enable them to report on suspicious behaviour on the part of these PEPs to their local FIUs (Chaikin, 2010:4).

Despite the fact that not all PEPS are corrupt, it is essential that FI realise that there are risks associated with dealing with PEPs and that these risks have to be mitigated by applying EDD to these individuals. Risks may also be mitigated by ensuring that senior management as well as internal audit and compliance staff members are both committed to and fully involved in the EDD procedures which are applicable to PEPS (MENAFATF, 2008:5, 6).

7.5.2 The Third Anti-Money Laundering Directive

The Third AMLD requires that EU Member States should adopt “appropriate risk-based” procedures in order to identify when a client is a PEP, whether the client is living in another Member State or in a third country.(European Union, 2005:L309:25). The Implementing Directive states that, when a person has not fulfilled a prominent public function for at least one year, such a person will no longer be considered to be a PEP. However, this does not adversely affect the requirements in respect of applying EDD on a risk sensitive basis (European Union, 2006:L214, 32). In its report on the application of the Third AMLD, the European Commission recommended that, in accordance with the FATFR, guidance should be made available on the RBA to be applied to those PEPs who have ceased to occupy a prominent public function for more than one year (EC, 2012:8).

7.5.3 The United Kingdom

When applying an RBA, FI must start from the premise that the majority of their clients are not money launders but they should then proceed, based on measures determined by the FI in question, to identify which clients may pose a higher ML risk that others. In terms of an

RBA, the risk management systems and procedures that FI employ should be both cost effective and also proportionate to the risks involved **(**JMLSG, 2011:20).

The MLR require that EDD should be applied on a risk-sensitive basis and that it include enhanced, ongoing monitoring in all areas that may pose a high risk of ML, as well as EDD to be applied to the establishment of a business relationship with a PEP (MLR, 2007:16).

Regulation 20(2)(c) of the MLR requires that policies and procedures that deal with risk management processes should be adopted and that these policies and procedures should specifically include a requirement to the effect that there is always duty to determine whether or not a customer is a PEP (MLR,2007:20). However, this regulation does not provide for situations in which an existing customer's status is changed to that of a PEP nor does it require that it be determined whether a beneficial owner of a customer is a PEP (FATF, 2009:11). The JMLSG has recommended that FI should use an RBA to decide whether the enhanced, ongoing monitoring of a PEP is to continue after the PEP has left the position for more than a year. However, in order to mitigate the threats associated with higher risk PEPs, FI may continue with enhanced monitoring for extended periods of time (JMLSG, 2011:100).

7.5.4 South Africa

There is restricted provision for applying an RBA in terms of the FICA in respect of establishing and verifying a client's identity and, irrespective of whether a client is a high or a low risk client, FI use the same standard in identifying these clients. The FIC did, however, provide Guidance Notes indicating that, unless an exemption has been published, the identities of all clients must be established. These Guidance Notes indicate the basis on which an RBA may be applied, indicating that a "one-size-fits-all approach" is not necessary but that the higher the risk a client poses for the purposes of ML, the higher the requisite verification requirements that must be applied (FATF/ESAAMLG, SA, 2009:28).

The FICA also requires that all accountable institutions establish and verify the identity of a client before a single transaction is concluded or before a business relationship established with such a person (FICA, Section 21). These KYC provisions must be applied, irrespective of the level of risk that a client may pose for ML purposes. Guidance Notes issued by the FIC do, however, provide that accountable institutions may use an RBA in determining the level of verification required in respect of clients' identities (FATF/ESAAMLG, SA, 2009:89). Guidance Note 3 indicates that, as regards the FATF 40 + 9, PEPs are to be regarded as

high risk clients; to whom CDD must be applied, with banks also adopting risk management procedures that will enable them to identify whether a new client or beneficial owner is a PEP (FIC, 2005:29). Banks are further required to ensure that PEPs form part of their overall risk management frameworks and that they are also addressed in the bank's group of companies' money laundering control policy (FIC, 2005:30).

7.6 ULTIMATE BENEFICIAL OWNERS AND POLITICALLY EXPOSED PERSONS

7.6.1 The Financial Action Task Force

The FATF Methodology Papers required that FI, in accordance with their risk management systems, identify whether a new or existing client is a PEP, and whether the beneficial owner of such a client is a PEP(FATF,2004b:19). Where an existing customer becomes a PEP, senior management should approve whether such a business relationship with the PEP may continue while determining the source of the wealth and funds of a PEP also applies to determining the source of the wealth and funds of the clients and beneficial owners who have been identified as PEPs (FATF, 2004b:20).

The FATFR has also recommended that the beneficiaries or owners of life insurance policies should be identified by FI, at the very least when the benefits are due in terms of the cover provided. Where higher risks are then identified, senior management should be made aware of the fact, with an examination taking place of the established business relationship with the owner of such a policy and, where necessary, FI should then file suspicious transactions (FATF, 2013a:47).

7.6.2 The Third Anti-Money Laundering Directive

The Third AMLD includes in the term PEP persons known to be close associates, including those persons who are known to have joint beneficial ownership of legal entities, or any other close business relationship, with such a PEP. The Third AMLD also includes in the term PEP an individual who acts as a sole, beneficial owner of a legal entity or legal arrangement, which has been created for the benefit de facto of a PEP (European Union, 2006:L214/31, 32).

7.6.3 The United Kingdom

According to the MLR, CDD implies that a beneficial owner should be identified when the beneficial owner is not the client. Thus, FI should identify, on a risk-sensitive basis, these beneficial owners (MLR, 2007:10). Regulation 20(2)(c) requires that policies and

procedures should be adopted that deal with risk management processes and that these policies and procedures should specifically include a requirement that there is always a duty to determine whether a customer is a PEP (MLR,2007:20). However, this regulation does not require that it be determined whether a beneficial owner of a customer is a PEP (FATF, 2009:11).

7.6.4 South Africa

The EDD to be applied by a bank when a potential client is a PEP includes the requirement that the source of funds or wealth of such a client and the beneficial owners identified as PEPs, should be determined. Guidance Note 3 indicates that PEPs are high-risk clients, and, thus, that an intensified enquiry is to be conducted when a beneficial owner of assets is a PEP (FIC, 2005:30).

However, weaknesses have been identified in Guidance Note 3, including the fact that it refers to the Wolfsberg Group principles as best practice for dealing with PEPs, instead of referring to the South African legal framework as authority for these guidelines. Furthermore, the South African regulatory and legal frameworks include no requirements as regards the identification of beneficial owners, and yet this is a requirement in this guidance note (FATF/ESAAMLG, SA, 2009:104).

7.7 THE PERIOD FOR WHICH A PERSON REMAINS A POLITICALLY EXPOSED PERSON

7.7.1 The Financial Action Task Force

The FATF 40 + 9 do not stipulate any time limits as regards indicating when a PEP will no longer be considered to be a PEP, once such a person has left office. However, in view of the emphasis that the FATF has placed on FI utilising an RBA in their AML measures, it is expected that FI should also apply an RBA in this regard. Nevertheless, stipulating specific periods for which a PEP would no longer be classified as such has proved to be both impractical and also out of touch with what happens in reality, namely, that PEPS are able to launder the proceeds of their corruption for many years after they have left office (Greenberg et al., 2010:31).

7.7.2 The Third Anti-Money Laundering Directive

The Third AMLD requires that EDD be applied to PEPs living in a foreign country or another Member State only and that these requirements apply for a period of one year only after a PEP has ceased to function as a PEP. Where a person has ceased to be entrusted with a prominent public function, the Implementing Directive indicates that such a person will, after the expiry of one year, no longer be considered to be a PEP (European Union, 2006:L214/32).

The Commission of the European Parliament and Council was requested to submit a report on the application of the Third AMLD as well as the FATFR thereon (EC, 2012:2). The Commission recommended that, in lieu of applying a fixed term during which a PEP would no longer be considered to be a PEP, institutions should adopt an RBA in deciding when the EDD requirements applicable to PEPs should cease to be applicable (EC, 2012:8).

7.7.3 The United Kingdom

The MLR require that policies and procedures should be adopted that deal with risk management processes and should these policies and procedures specifically include a requirement that there is always a duty to determine whether a customer is a PEP (MLR, 2007:20). The definition of PEP contained in the MLR includes a person who, in the preceding year has been or still is, entrusted with a prominent public function. However, a PEP will no longer be regarded as such after a year has passed since he/she left office. The JMLSG advised that FI should apply an RBA in order to determine whether the EDD of the transactions of such a person should cease after a year. However, in order to mitigate the risk associated with such a client adequately, it may be necessary that such monitoring be carried out for longer than a year (JMLSG, 2011:100).

7.7.4 South Africa

In South Africa PEPs are defined as persons who are, or have in the past, been entrusted with a prominent public function (FIC, 2005:28). However, the FICA does not stipulate any requirements in respect of which a person will no longer be regarded as a PEP.

7.8 WHEN EXISTING CLIENTS BECOME PEPS

7.8.1 The Financial Action Task Force

FI may employ various measures with regard to identifying PEPs and managing their relationships with these individuals. It has been suggested that, as regards existing clients, EDD should be applied to these individuals once their status has changed to that of a PEP (MENAFATF, 2008:6).

7.8.2 The Third Anti-Money Laundering Directive

It is incumbent on EU Member States ensure that institutions and persons that come under the auspices the Third AMLD, with regard to transactions or business relationships with PEPs, should employ efficient risk-based systems in order to determine whether a client is a PEP (European Union, 2005:L309/25). However, there is no reference made to whether such a client is to be a new or an existing client.

7.8.3 The United Kingdom

The MLR require that policies and procedures that deal with risk management processes should be adopted and should these should include a specific requirement to the effect that there is always a duty to determine whether a customer is a PEP (MLR, 2007:20). However, the MLR do not provide for situations in which an existing customer's status changes to that of a PEP (FATF, 2009:11).

7.8.4 South Africa

Guidance Note 3 requires that banks, in respect of PEPs who are high-risk clients, should have adequate risk management systems in place in order to be able to determine whether a client, potential client or beneficial owner is a PEP (FIC, 2005:29,30). It would appear that banks must be able to determine when an existing client's status changes to that of a PEP.

7.9 ENFORCEMENT WITH REGARD TO REGULATORY REQUIREMENTS IN RESPECT OF POLITICALLY EXPOSED PERSONS

7.9.1. The Financial Action Task Force

Several of the FATF Recommendations may be utilised effectively to mitigate the risks posed by PEPs. ML offences are deemed to apply to a wide range of predicate offences, including corruption and bribery in order to curb the crimes committed by corrupt PEPs. The

FATF 40 + 9 includes measures dealing with confiscation and which are crucial as regards returning funds which have been illicitly taken from countries. In addition, there are the requirements stipulating that there has to be international co-operation in respect of asset recovery, that countries should provide each other with mutual legal assistance and assist each other in the extradition of criminals. Suspicious transaction reports must also be filed in instances of corruption and bribery. FIUs should also be established in such a way that they are able to operate independently of government interference (FATF, 2010a: 48, 49). FI should ensure that they comply with their countries' PEP regulatory frameworks while FIUs should be able to identify any FI which are not complying with PEP regulations, oblige these FI to comply and ensure that strict follow ups are conducted in this regard. It is essential that FIUs pay specific attention to PEP compliance during their inspections of FI (MENAFATF, 2008:8).

7.9.2 The Third Anti-Money Laundering Directive

EU Member States are compelled to ensure that they monitor and apply processes to ensure that entities which fall within the ambit of the Third AMLD comply with its requirements (European Union, 2005:L309/30). Member States have their own FIUs, which, collectively, constitute the EU's FIUs Platform. This platform acts as an informal organisation and was created by the European Commission. FIU analyse the information provided to them and then provide this information to prosecutors and law enforcement agencies so as to facilitate their dealing with transgressions by way of investigations and, if necessary, further legal actions against the offenders (EU, FIU, 2008:2, 3).

7.9.3 The United Kingdom

The FSA published its report on Banks' Management of High Money-Laundering Risk Situations in 2011 and reported that the majority of banks visited were not managing their PEP relationships efficiently and that they had to exercise greater vigilance to ensure that they were not used for the purposes of ML (FSA, 2011a:6).

The FSA had conducted this thematic review of the banks' management of high ML risk areas in 2010 and, as a result thereof, had found that Coutts & Company were not employing EDD when engaging with high risk customers and also that enhanced monitoring of these relationships was not being conducted on a regular basis. Specifically with regard to PEPs the FSA found that Coutts & Company failed to obtain adequate information on the source of their wealth, did not obtain and use undesirable information obtained about PEPs,

the information on their PEPs was not maintained adequately and there was insufficient monitoring conducted of PEP transactions. Subsequently, Coutts & Company was fined a sum of £8,75 million for not creating and maintaining efficient AML procedures and controls with regard to PEPs (FSA,2012b).

Companies that are regulated in the United Kingdom and fall under its AML regulatory framework and have offices that operate internationally or have subsidiaries that operate internationally, are allowed to use their discretion regarding whether or not to apply EDD to former PEPs. This becomes extremely important where the regions where they are operating are known for their high levels of corruption and ML (Choo, 2008:378). This has proved to be very valuable, as in the case of Nigerian Governors who, while they were in these positions, were prosecuted successfully for corruption and ML in the United Kingdom, despite the fact that these PEPs enjoyed immunity under their own Nigerian constitution (Chaikin & Sharman, 2009:89–90).

7.9.4 South Africa

Guidance notes issued by the FIC are not regarded as legally enforceable and there are currently no sanctions being applied by the FIC if non-compliance is identified therewith (FATF/ESAAMLG, SA, 2009:88).

7.10 SUMMARY

The review of the FATF 40 + 9 resulted in PEPs being included as customers who must be identified. This was based on the increased awareness of the link between corruption and ML. The FATF 40 + 9 includes EDD measures that must be undertaken in respect of PEPs, in addition to the normal CDD (Johnson, 2008a:292). The FATF 40 + 9 define a PEP as a person who is or has “been entrusted with a prominent public function in a foreign country” (FATF, 2003:17).

In the United Kingdom the MLR include measures on how to deal with PEPs. The MLR require that FI adopt appropriate AML risk management procedures that will include provisions that require the identification of PEPs, but do not apply to when an existing customer becomes a PEP or as regards determining whether a beneficial owner of a client is a PEP (FATF, 2009:11).

EU Member States have been provided with a definitive regulatory PEP framework in the Third AMLD. The Third AMLD is founded on the FATF 40 + 9 requirements in respect of

PEPs, but also contains further requirements such that EDD is required in respect of PEPs who live in a foreign country only. The EU has also published Implementing Measures on PEPs which clarify the definition of PEPs and which provide specific categories of persons who should be regarded as PEPs (Greenberg et al., 2010:19).

At present the South African AML regulatory framework contains no enforceable requirements for accountable institutions as regards dealing with PEPs as required in terms of the FATF 40 + 9 (FATF/ESAAMLG, SA, 2009:103). In 2005, the FIC published Guidance Note 3, in which PEPs have been defined with reference made to the fact that the Wolfsberg principles on PEPs should be used as guidance on how to identify and deal with these individuals (FIC, 2005:30). However, this Guidance Note is applicable to banks only; it is not included in the AML regulatory framework of South Africa and cannot be considered to represent other enforceable means as defined by the FATF (FATF/ESAAMLG, SA, 2009:103, 104).

CHAPTER 8 CONCLUSION AND RECOMMENDATIONS

8.1 SUMMARY OF FINDINGS

8.1.1 MONEY LAUNDERING: A GLOBAL PROBLEM

ML may be defined as the practice in terms of which criminals ensure that the proceeds of their crimes appear legal. This is accomplished by hiding and disguising these illicit proceeds. It is estimated that billions are laundered every year, thus making ML a serious international problem (Bachus, 2004:835). There has been an increased focus internationally on the link between ML and corruption and various cases have been identified in which extremely wealthy persons, who occupied prominent public positions, acquired their fortunes illicitly by embezzling government funds (Choo, 2008:372).

The media has reported on various cases in which PEPs have been involved in corruption, and these are, which have served, in part, as motivation that PEPs should be included in the international AML framework. ML offences committed by PEPs range from embezzlement, bribes, tax fraud, and theft of state assets to involvement in organised crime (FATF, 2004a:19). Accordingly, the FATF has ranked PEPs as high risk for the purposes of ML and, more specifically, when corruption is involved (APG/FATF, 2007:34).

The effects of ML and corruption are devastating with ML and corruption seriously impeding the development of countries and affecting the way in which investors view such countries. This, in turn, leads to capital flight and to decreased economic stability. In addition, ML and corruption seriously hinder a country's growth prospect and attempts to alleviate poverty while government departments may lose their credibility and financial systems can be disrupted as a result of prolonged ML and corruption. It is only political will, executed at government level, which would be able to restrain ML and corruption efficiently (Greenberg et al., 2010: xiii).

8.1.2 INTERNATIONAL AND SOUTH AFRICAN AML REGULATORY FRAMEWORKS

The FATF was created with the purpose of putting an end to ML and, thus, with this obligation, the FATF set out to create measures for combating ML. Since 1990, various sets of Recommendations have been issued by the FATF, with the aim of devising AML measures. After 9/11, the recommendations were revised to provide for an additional 9 recommendations on TF (Haigner et al., 2012:38). The FATF has been mandated to create principles for combating ML, and to ensure that these principles are implemented on a

legal, regulatory and operational level. The Recommendations have created standards on AML measures, which countries then adapt to their unique circumstances. The FATF 40 + 9 contain certain vital measures that countries must implement as part of their AML framework. Internationally, the FATF recommendations are recognised as the global standard on AML measures (FATF, 2012a:7).

In the EU, the Third AMLD has been adopted to ensure that FI are protected against the risks posed by ML. The Third AMLD is predominantly based on the FATF 40 +9, with Member States having to implement its requirements in their own jurisdictions (EC, 2012:2).

The AML regulatory framework in the United Kingdom is embodied in the Proceeds of Crime Act 2002 and the MLR. The Proceeds of Crime Act 2002 contains the criminal law provisions with regard to ML and, in accordance with the Act's definition of ML, an all crimes approach is adopted with regard to ML. The MLR were adopted to ensure that the United Kingdom, as a member state of the EU, would implement the Third AMLD. The MLR were revised in 2007 to ensure that its AML measures corresponded with those of the FATF 40 + 9 (Leong, 2007:143).

In South Africa, the POCA was implemented in order to ensure that ML qualified as a criminal offence. The FICA was promulgated as a control measure to identify and investigate cases of ML (FIC, 2010c:1). In addition to the FICA, the South African AML regulatory framework consists of Regulations and Exemptions published as preventive measures against ML. Guidance Notes have also been issued by the FIC, but are not regarded as the "other enforceable means", as required by the FATF (FATF/ESAAMLG, SA, 2009:88).

8.1.3 ADOPTING A RBA TO AML MEASURES

As indicated in the FATF 40 + 9, countries and FI are permitted to use an RBA in combating ML. This, in turn, implies that resources may be applied to those areas of ML that carry the greatest risks. The benefit of employing an RBA to AML measures is that resources may be allocated more efficiently, instead of applying a tick box methodology to comply with the Regulators' requirements as the latter does not adequately mitigate the risks that ML may pose (FATF,2007a:2). In the FATFR, the emphasis is on applying an RBA to combating ML. Once countries have identified their unique ML risks, implementing an RBA to their AML measures will ensure a more efficient mitigation of the ML risks in their jurisdictions (FATF, 2012a:8).

However, not all PEPs are corrupt and, thus, not all PEPs pose the same risk. It has been proposed that a risk based KYC should be applied to PEPs. As part of adopting an RBA to a FI's management of its PEPs, the FI may choose to not differentiate between domestic and foreign PEPs. In accordance with such an RBA, enhanced ongoing monitoring may be undertaken, based on the risks identified, and EDD may even be extended to include clients from embassies and foreign consulates in the FI's country (Choo, 2008: 375, 376).

8.1.4 THE IMPORTANCE OF PEPS

In the past few decades there has been an increased focus on PEPs and their involvement in corruption. They have been observed to hide their illicitly gained wealth through the use of shell companies, close associates, family members and off-shore banks (FATF, 2004a:1). The FATF consider PEPs to be one of the main groups of clients that are considered to be of a high-risk category for ML purposes. PEPs have access to government funds which may be embezzled or they may be involved in self-dealing as a result of their ability to award government contracts (FATF, 2011:9).

The effects of corruption on a poor country may be overwhelming and the corruption on the part of just one PEP has the potential to disrupt a country's economic stability significantly. There are numerous risks that PEPs pose; including the legal and reputational risks they pose to FI in addition to a loss of confidence in the integrity and stability of entire financial structures (Greenberg et al., 2010:16).

Research conducted on the basis of the mutual evaluation reports of the FATF and various AML organisations has indicated that there is low compliance with the FATF 40 + 9 requirements in respect of PEPs with the majority of FATF members being observed to be non-compliant with these Recommendations (Johnson, 2008a:298).

There is no international definition of a PEP and various definitions have been adopted by the FATF and by other AML regulatory frameworks. Instead of compiling an international list of PEPs that would assist criminals as regards ML, as it would provide them with knowledge of individuals with whom not to associate with, it has been suggested that an RBA should always be employed in managing PEPs and the ML risk they pose (Choo, 2008:372, 373).

It is possible for developing countries both to detect and to prevent corruption if they improve their local AML measures. There has been a proliferation of AML structures and organisations on an international level and these may serve as an efficient tool in the fight

against corruption. These AML structures and organisations may be of great use in bringing corrupt PEPs to task (Chaikin, 2010:5).

8.1.5 ANTI-MONEY LAUNDERING REGULATORY FRAMEWORKS RELEVANT TO POLITICALLY EXPOSED PERSONS

The FATF 40 + 9 requires that, in addition to the usual CDD, PEPs should be subjected to EDD measures which include the following: FI should be able to identify when a client is a PEP, senior management approval should be obtained before establishing a business relationship with such a client, a PEP's source of funds should be determined and a business relationship with a PEP should be subject to enhanced monitoring on an ongoing basis (FATF, 2003b:5, 6). PEPs are defined as individuals who currently are, or in the past have been, entrusted with a prominent public function in a foreign country (FATF, 2003b:17).

In the EU, the Third AMLD provides for PEP regulation in its Member States. The Third AMLD defines a PEP as an individual who is or has been entrusted with a prominent public function, and the families and close business associates of such an individual (European Union, 2005:L309/22). The Implementing Directive to the Third AMLD provides greater clarity on PEP regulation and requires that, using an RBA, EDD be applied to PEPs living in other Member States or foreign countries (European Union, 2006:L214/29). The Implementing Directive proceeds to provide examples of individuals who would be considered to be PEPs (European Union, 2006:L214/31).

PEP regulation in the United Kingdom is dealt with in the MLR. The MLR requirements in respect of EDD measures to be applied to PEPs are similar to the EDD measures contained in the FATF 40 + 9. The MLR definition of PEPs is similar to that contained in the FATF 40 + 9, but limits the positions occupied by PEPs to countries outside of the United Kingdom or with an international organisation or community institution. The MLR indicate that such PEP status applies to the previous year of occupying such a position only (MLR, 2007:16).

In South Africa, there is currently no enforceable PEP regulation (FATF/ESAAMLG, SA, 2009:103). The FIC issued Guidance Note 3, which is directed at banks only and which set out the requirements for dealing with PEPs (FIC, 2005:6). It indicates that the Wolfsberg Group principles should be used as best practice in dealing with PEPS and, thus, it uses

the definition of PEPs and the EDD as applicable to PEPs as contained in the Wolfsberg Group principles as required regulation for these individuals (FIC, 2005:28).

8.1.6 A COMPARATIVE OVERVIEW OF ANTI-MONEY LAUNDERING REGULATORY FRAMEWORKS RELEVANT TO POLITICALLY EXPOSED PERSONS

REGULATORY FRAMEWORKS

The FATF 40 + 9 sets out a broad framework of principles that countries must adopt in implementing AML measures in their respective regions. However, the FATF 40 + 9 is not regarded as mandatory regulation applicable to all countries, but is regarded as the global standard for AML (World Bank, 2006: III-9). Recommendation 6 of the FATF 40 + 9 contains specific requirements with which FI must comply when engaging with PEPs (FATF, 2003b:5).

The member states of the EU are also members of the Council of Europe, which devises legislation that is applicable to all member states. Competent authorities of the EU formulate mandatory legal duties that have sovereignty over the legislative frameworks of the member states and are subject to enforcement by the EU. In this regard, the Third AMLD was issued and applies to all member states of the EU (Türksen, Misirlioglu & Yükseltürk, 2011:286). The Implementing Directive expounds upon the definition of PEPs and provides examples of persons who would qualify as PEPs (European Union, 2006:L 214/29).

In the United Kingdom, main legislation is referred to as “Acts”, while, in terms of these Acts, secondary legislation may be issued and is known as regulations. The MLR which became effective in 2007 is regarded as legislation in terms of the AML methodology (FATF, 2009:6). The MLR contain a definition of PEPs and also stipulate the EDD measures that must be applied to these persons (FATF, 2009:9).

In South Africa, AML/CFT measures have been implemented by the FICA as well as the Money Laundering and Terrorist Financing Regulations and Exemptions in terms of the FICA (FATF and ESAAMLG, 2009:8). The FICA provides for guidance to be issued and, in this regard, issued Guidance Note 3, which defines PEPs and addresses the EDD to be applied to PEPs. However, Guidance Note 3 is not regarded as law, regulation or other enforceable means and, thus, the FICA contains no enforceable duty in terms of which PEPs must be identified or EDD applied to such PEPs (FATF and ESAAMLG, 2009:103, 104).

Thus, while the FATF 40 + 9 and its requirements with regard to PEPs, although not legislation, are regarded as the international AML standard to be adopted by all countries, the EU and United Kingdom have adopted regulatory requirements with regard to PEPs in their respective legislative frameworks, with the necessary mandatory requirements and enforcement attached thereto. In South Africa, however, no enforceable legislative requirements with regard to PEPs have been adopted into the existing AML framework.

APPLICATION

The FATF 40 + 9 indicate the measures that countries must take to criminalise ML, ensure the confiscation of the proceeds of crime and prevent ML (FATF, 2003b:3, 4). The Recommendations which deal with CDD and EDD for PEPs, apply specifically to FI (FATF, 2003b:4, 5).

The FATF defines a FI as a natural or legal person who, as a business conducts, amongst others; deposit taking, lending, money transfer services, issuing and managing means of payment, portfolio management and money and currency changing on behalf of a client. This would also include the placement of life and investment related insurance and the investment, administration and management of funds on behalf of other persons (FATF, 2012a:115, 116).

The Third AMLD requires that all EU Member States should ensure that ML is forbidden in their respective regions, whilst the Directive applies specifically to FI, credit institutions, auditors, notaries, trust and company service providers, casinos, real estate agents as well as legal and natural persons who trade in goods where cash payment take place, in excess of EUR 15000, 00 (EU, 2005: L309/20, 21).

The MLR apply to all FI as defined by the FATF 40 + 9 (FATF, 2007b:158). Accordingly, the MLR also apply to accountants, auditors, lawyers, trust or company service providers, estate agents and high value dealers. The MLR regulate all 13 “financial activities” conducted by entities, as identified by the FATF 40 + 9. The regulation of designated non-financial businesses and professions is also covered in the MLR (FATF, 2009:5) The FICA applies to certain FI which are referred to as accountable and reporting institutions. In addition, it contains limited applicability to all businesses. Accountable institutions include banks, long-term insurance companies, estate agents, attorneys, auditors and financial advisers dealing with investments (De Koker, 2003:168). The FIC issued Guidance Note 3, directed at banks only, which sets out the requirements for dealing with PEPs (FIC,

2005:6). However, the FICA contains no enforceable PEP regulation. Although the FIC issued Guidance Note 3 which deals with PEP regulation, it is limited in scope in that it applies to banks only and is not regarded as " other enforceable means", as defined by the FATF (FATF/ESAAMLG, SA, 2009:103).

8.2 SUGGESTIONS FOR THE APPLICATION OF THE RESEARCH

The South Africa AML regulatory framework contains no enforceable duty on FI to determine whether a client is a PEP, or to conduct any other requirements stipulated in the FATF 40 + 9 in respect of PEP regulation. Accordingly, South Africa may be regarded as being non-compliant with the FATF 40 + 9 standards for PEP regulations (FATF/ESAAMLG, 2009:108). Despite Guidance Note 3 that has been issued by the FIC and which deals with PEP regulation by banks, Guidance Note 3 carries no legal obligation as it does not comply with the FATF description of "other enforceable means" (FATF/ESAAMLG, 2009:109). The FATF guideline on what constitutes "other enforceable means" include the following: the document should address matters indicated in the FATF 40 + 9, be issued by a competent authority, contain wording that indicates that compliance therewith is mandatory and indicate sanctions for non-compliance (FATF, 2004b:9, 10).

The United Kingdom revised its MLR in 2007 to bring the MLR into line with, inter alia, the FATF 40 + 9 requirements with regard to PEPs and as a response to the FATF's Mutual Evaluation Report that had indicated the United Kingdom's non-compliance with PEP provisions (FATF, 2009:5).

It is recommended that the South African Regulatory Framework incorporate efficient PEP regulation into its AML Regulatory Framework, by revising the current ML and Terrorist Financing Control Regulations so as to provide for EDD to be applied to foreign and domestic PEPs by all accountable institutions.

There is no internationally accepted definition of a PEP. In addition, in the FATF, United Kingdom and EU regulation of PEPs, certain areas have been identified that have proved to be challenging to FI and regulators, which may possibly be regulated more efficiently. South Africa should use this opportunity to revise its PEP regulation by incorporating it into its AML Regulations and setting down PEP regulations that address all the above-mentioned challenges.

Recommendations on PEP regulation which may be included in such revised regulations and regulatory framework include –

- *The definition of a PEP must refer to both domestic and foreign PEPs and include their family members and close associates* (FATF, 2012a:16). It is not reasonable to assume that foreign PEPs only may be corrupt. The financial transgressions on the part of public servants in the South African Government increased from R 100 million in the 2008-09 years to R 932 million in the 2010-11 years (Ensor, 2012).

- *Applying an RBA to PEPs and ongoing monitoring of their accounts* (FATF, 2012a:31). Establishing a business relationship with a PEP poses very unique problems, with the result that the usual CDD measures may not prove adequate when dealing with individuals that pose such a high risk of ML (Choo, 2008:375). FI would be able, when applying an RBA to their PEP management, to identify risks applicable to their unique situations and to apply their resources efficiently to their areas of highest risk.

- *FI should be required to determine whether a beneficial owner is a PEP* (FATF, 2012a:16). It should be considered as a warning sign when legal structures that have been created serve no apparent purpose, or they have been created in such a way that they involve complicated ownership arrangements (Choo, 2008:377). It has been noted that such legal entities are often created specifically to hide the identity of the beneficial owner. PEPs have also evolved in the ways in which they hide the proceeds of their corruption, for example, they use such complex legal entities in order to hide their identities.

- *No specified periods should apply where after a PEP will no longer be considered to have such status* (MENAFATF, 2008:7). The MLR indicate, that 12 months after leaving office, a PEP should no longer be classified as such. Nevertheless, this proviso does reflect the reality that a PEP may pose a serious ML risk long after he/she has left office (Choo, 2008:383).

- *FI must maintain current and applicable information on their clients and should be able to determine when an existing client's status changes to that of a PEP*. The FATF has indicated that PEPS are to be regarded as high risk clients with regard to ML. It is, therefore, crucial that FI should become aware of the fact when one of their existing client's status changes to that of a PEP (MENAFATF, 2008:3).

In addition to revising its Regulations, the FIC could issue guidance to FI, which would comply with the FATF definition of “other enforceable means”. Such guidance may include;

- Red flags that FI must employ to identify close associates of PEPs
- The manner in which the source of funds and wealth must be identified and verified
- Indicators of corruption by providing typology reports
- Details of the way in which a suspicious transaction report in respect of a PEP must be filed (Greenberg et al., 2010:73–75).

8.3 RESEARCH LIMITATIONS

Research conducted in respect of the SA AML regulatory framework relevant to PEPs was restricted due to limited publications available in SA on this specific topic. The research was based on the SA regulatory framework as at 31 December 2012. Furthermore, it was assumed that countries have to date not been able to implement the FATFR.

8.4 FURTHER RESEARCH

Further research could be conducted into the following areas:

- This research paper was limited to a review of the EU and United Kingdom’s regulatory frameworks relevant to PEPs. However, the United States and Australia have also developed extremely efficient systems for the regulation of PEPs and these warrant a further comparative study.
- Research into PEP regulation by banks and other FI in South Africa may also prove fruitful in determining whether these accountable institutions are adhering to Guidance Note 3 or whether they are applying the more stringent management of PEPs as required by international standards.
- Asset forfeiture, which is employed as a measure with which to combat corruption and to regain assets which have been illicitly obtained by corrupt PEPs, may warrant further research, aimed at its specific applicability to South African regulation.
- Research into the extent of the corruption committed by PEPs in SA, with specific reference to reports issued by the Auditor General and Public Protector in this regard, may prove valuable.

- Domestic PEPs: International and national regulatory frameworks applicable to and management of these individuals.
- Close associates: Challenges in dealing with close associates of PEPs.

8.5 CONCLUSION

South Africa signed the UNCAC on 9 Dec 2003 and ratified it on 22 Nov 2004 (UNODC.2012b). In an effort to combat corruption, the UNCAC contains specific sections which are applicable to all state parties that require FI to apply EDD to all PEP accounts. In addition, the UNCAC requires its state parties to issue advisories in terms of their domestic law that will indicate when to apply EDD to clients, the categories of accounts and transactions to focus on and specific record keeping requirements in respect of these accounts (UNODC, 2004:42).

Despite the above, South Africa remains non-compliant with the FATF 40 + 9 requirements on PEPs, which may, in turn, suggest that South Africa is then even more non-compliant with the UNCAC and FATFR, which contains more stringent requirements with regard to PEPs than the FATF 40 +9.

The FICA contains no legislative or regulatory directive aimed specifically at PEPs. However, Guidance Note 3 issued by the FIC, which is aimed at guiding only banks in South Africa on customer identification, contains guidelines on PEPs. In terms of the FATF 40 + 9, all FI are required to apply EDD measures to PEPs. It is suggested that requirements with regard to PEP regulation be specifically incorporated into the FICA and its regulations in order to ensure that they are adequately enforced and, in line with the FATF 40 + 9 and FATFR, make them applicable to all FI. It is, therefore, evident that the South African AML regulatory framework does not comply with the FATF 40 + 9 on PEPs and that improved PEP regulation is required as regards South Africa's AML/CTF efforts.

The regulation of PEPs in South Africa has been compared to that of the FATF 40 + 9, the FATFR and other international AML regulatory frameworks, to determine whether international best practices are being followed in South Africa. The assumption has been made that if South Africa does not comply with the FATF 40 + 9 in respect of PEPs, then South Africa's non-compliance with PEP regulation under the FATFR is probably even more extensive.

The research problem stated that it will be determined whether the South African AML regulatory framework complies fully with the FATF 40 + 9 on PEPs and whether improved PEP regulation is required for AML/CTF efforts in South Africa. The research has indicated that the South African AML regulatory framework does not comply entirely with the FATF 40 + 9 on PEPs indicating that improved PEP regulation is required for AML/CTF efforts in South Africa

It is possible to combat corruption effectively if efforts are made to create a culture of integrity, transparency and accountability within a country. Corrupt PEPs may cause serious reputational damage to a country and this, in turn, may lead to political and economic instability and cause capital flight (Campos & Pradhan, 2007:418). A well-developed AML system may aid significantly in combating corruption in a country (Chaikin, 2010:6). However, it is only if a country has the necessary political will at the most senior levels in government that it will be able to combat corruption efficiently and also ensure that corrupt PEPs are not able to enter any financial system (Greenberg et al., 2010:xiii).

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