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***Customer due diligence as a  
countermeasure against money laundering  
in South Africa***

By

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## Declaration

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November 2021

## Summary

The purpose of this research is to discuss customer due diligence as a countermeasure against money laundering in South Africa. After setting out the meaning of and background to money laundering as financial crime, the discussion considers various anti-money laundering initiatives, such as South African statutes and international best practice. The latter serves as foundation to consider customer due diligence more closely, including an explanation of the risk-based approach and the manner in which customer due diligence is conducted. Conclusions are then drawn regarding the importance of customer due diligence, along with certain recommendations.

**Keywords:** anti-money laundering; customer due diligence; money laundering; risk based approach

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# Chapter 1:

## Introduction and background to the study

### 1.1 Introduction

Anti-money laundering initiatives were designed with the aim to fight, detect and prevent money laundering. These initiatives comprise of legislation, organisations and civil remedies. These initiatives assist financial institutions in preventing the people who engage in financial crime from enjoying the earnings that they obtained from illegal undertakings. South Africa is among the numerous countries that recognise the importance of anti-money laundering processes.

Relevant international organisations include the Financial Action Task Force and the Bank for International Settlements.<sup>1</sup> Moreover, the impact of the international organisations has permitted a vast number of countries to apply anti-money laundering processes. In South Africa, the Financial Intelligence Centre Act 38 of 2001 (FICA) manages the obligation to obtain and authenticate the identity of customers prior to entering into individual financial transactions or new business relationships. This obligation originated in June 2003 and has been adopted by most financial institutions. The obligation to identify customers and authenticate their identity is part of the processes to fight money laundering in South Africa.<sup>2</sup>

Simply put, money laundering is an action aimed at hiding the origins of earnings emanating from illegitimate undertakings. It comprises of any action that qualifies as an offence in terms of FICA and the Prevention of Organised Crime Act 38 of 1998 (POCA).

Considering the above, the purpose of the dissertation is to analyse customer due diligence as a countermeasure against money laundering in South Africa. South Africa's measures to fight money laundering and other financial crime will work effectively if the financial system in the country is crystal clear (based on robust customer due diligence measures) to ensure that sufficient information is recorded in the books of financial and other institutions and to make the sharing of information that may support further investigation of money laundering and other financial crimes

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<sup>1</sup> <https://www.fatf-gafi.org/faq/moneylaundering/> (accessed 19-07-2021).

<sup>2</sup> <https://www.trulioo.com/blog/kyc> (accessed 10-07-2021).

possible.<sup>3</sup> In layman's terms, unless an accountable institution knows who they are dealing with, they will have difficulties identifying suspicious transactions related to that customer. The suspicion is brought about by the understanding or knowledge of the customer, the business and the source of the customer's income.

## 1.2 Background of the study

Money laundering is mainly regulated in the Prevention of Organised Crime Act 121 of 1998 (POCA)<sup>4</sup> and the Financial Intelligence Centre Act 38 of 2001 (FICA).<sup>5</sup> POCA was the first statute to provide a definition of the different money laundering offences. On the other hand, FICA established the Financial Intelligence Centre which became the leading structure in providing money laundering control obligations for financial organisations.

The Drugs and Drug Trafficking Act was the first statute to regulate money laundering in South Africa.<sup>6</sup> The statute was enacted to fight financial crimes such as money laundering in South Africa. Its success was limited because it was more focused on drug-related crimes in South Africa.

In 1996, the Proceeds of Crime Act was enacted and specified that money laundering arose from any gains from criminal activities.<sup>7</sup> This statute extended money laundering offences to include proceeds of all crimes and regulated the confiscation of the proceeds of conviction.<sup>8</sup> Both the Drugs statute and Proceeds of Crime statute were repealed by POCA in 1998. All money laundering offences were combined into one statute.<sup>9</sup>

When FICA was enacted in 2001. There was no statutory regulation of the concept of customer due diligence in South Africa. The enactment of FICA can be traced back to 1996<sup>10</sup> when the Money Laundering Control Bill was published by the South African Law Commission.<sup>11</sup> That Bill provided regulations and measures of

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<sup>3</sup> <https://www.derebus.org.za/financial-intelligence-centre-amendment-act-gazetted/> (accessed 19-08-2021).

<sup>4</sup> Sections 4-6 of the Prevention of Organised Crime Act 121 of 1998.

<sup>5</sup> Financial Intelligence Centre Act 38 of 2001.

<sup>6</sup> Section 14 of the Drug and Drug Trafficking Act 140 of 1992.

<sup>7</sup> Proceeds of Crime Act 76 of 1996.

<sup>8</sup> Sections 8-14 of the Proceeds of Crime Act 76 of 1996.

<sup>9</sup> L De Koker "Money laundering control: The South African model" 2003 *Journal of Money Laundering Control* 166.

<sup>10</sup> L De Koker "Money laundering control: The South African model" 2003 *Journal of Money Laundering Control* 168.

<sup>11</sup> South African Law Commission "Money Laundering and Related Matters" Discussion Paper 64 1996.



controlling money laundering but the government failed to take immediate action on it.<sup>12</sup>

FICA is used simultaneously with POCA to fight money laundering in South Africa. The anti-money laundering provisions oblige financial organisations to identify and verify customers whom they conduct business with.<sup>13</sup> Financial organisations are also required to keep records, client profiles and report any suspicious accounts.<sup>14</sup> This marked the first steps towards the reliance on customer due diligence to fight money laundering in South Africa.

FICA states that financial organisations may not enter into or conclude working relationships unless the customer's identity has been established and verified.<sup>15</sup> This requirement applies even when a person is acting on behalf of another, and thus both parties should be identified.<sup>16</sup> The duty to identify extends to the monitoring of the customer's source of funds to determine the consistency of the customer's transactions.<sup>17</sup> This helps financial institutions when grouping customers according to the money laundering risk they are likely to cause.

To date, the Amendment<sup>18</sup> Act is the major statutory regulation measure that provides procedures on how customer due diligence should be applied in the fight against money laundering. It also regulates how the reliance on customer due diligence can achieve the fighting of money laundering in South Africa.

### 1.3 Statement of the problem

Numerous countries have applied statutory provisions that regulate money laundering. In the past years, both South Africa and the United Kingdom have been creating regulations to cultivate universal participation against money laundering.<sup>19</sup> South Africa has adopted anti-money laundering laws and regulations influenced by

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<sup>12</sup> L De Koker "Money laundering control: The South African model" 2003 *Journal of Money Laundering Control* 169.

<sup>13</sup> Section 21 of the Financial Intelligence Centre Act 38 of 2001.

<sup>14</sup> Section 22A of the Financial Intelligence Centre Amendment Act of 2017.

<sup>15</sup> Section 21 of the Financial Intelligence Centre Act 38 of 2001.

<sup>16</sup> Sections 21(b) of the Financial Intelligence Centre Act 38 of 2001.

<sup>17</sup> Section 21C (a) of the Financial Intelligence Centre Amendment Act of 2017.

<sup>18</sup> Financial Intelligence Centre Amendment Act of 2017.

<sup>19</sup> N Mugarura "The Implications of Brexit for UK Anti-Money Laundering Regulations: Will the Fourth Anti-Money Laundering Directive be Implemented or be Binned" 2018 *Journal of Money Laundering Control* 5-21.

international standards such as the Financial Action task Force (FATF) recommendations in fighting money laundering.<sup>20</sup>

Numerous challenges could arise when customer due diligence measures or the implemented international standards are incompatible or poorly applied into the South African anti-money laundering laws on an extra territorial basis.<sup>21</sup> This could limit the South African enforcement authorities' reliance on customer due diligence to detect and prevent money laundering activities that are committed in South Africa or elsewhere by offenders in other jurisdictions where no such extra-territorial application exists.<sup>22</sup> Also, it could give rise to the poor enforcement of customer due diligence measures to prevent money laundering activities.

The concept of customer due diligence was developed to ensure that financial organisations get to know their customers.<sup>23</sup> The requirements for the identification and verification processes of financial customers by financial organisations is an effective measure that can help detect, fight and prevent money laundering in South Africa.

## 1.4 Aims and objectives

### 1.4.1 Aims

The aims of this dissertation are to:

- (a) examine the impact of money laundering in South Africa on society, businesses and the South African economy;
- (b) examine whether the customer due diligence provisions provided in the Amendment Act will be successfully utilised by the relevant authorities to control money laundering in South Africa;
- (c) evaluate whether the risk management and compliance programme which has been employed in the FICA is robust enough to prevent the risks

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<sup>20</sup> N Mugarura "The Implications of Brexit for UK Anti-Money Laundering Regulations: Will the Fourth Anti-Money Laundering Directive be Implemented or be Binned" 2018 *Journal of Money Laundering Control* 80.

<sup>21</sup> C Goredema and F Monsti "Towards Effective Control of Money Laundering in Southern Africa-Some Practical Dilemmas" 2002 *African Security Review* 2, 3.

<sup>22</sup> L De Koker "The FATF's Customer Identification Framework: Fit for Purpose?" 2014 *Journal of Money Laundering Control* 281 and 290.

<sup>23</sup> L De Koker "Money laundering control: The South African model" 2003 *Journal of Money Laundering Control* 283.

associated with illegal activities such as money laundering in the South African financial organisations. In this regard, the research examines the scope and application of the relevant provisions of FICA for the purposes of detecting and preventing money laundering in South Africa. Moreover, the researcher discusses the role of selected South African anti-money laundering statutes in order to assess whether they are effective in fighting money laundering in South Africa;

- (d) investigate the current role of current customer due diligence statutory regulatory framework in order to recommend possible measures to enhance the enforcement of the South African anti-money laundering initiatives.

#### **1.4.2 Objectives**

In order to achieve the above-mentioned aims, the objectives of the research are to:

- (a) examine the overall impact of money laundering in South Africa on society, businesses and the South African economy;
- (b) discuss the role of the South African anti-money laundering initiatives and enforcement authorities. This is done to investigate whether these statutes are effective in discouraging money laundering activities in South Africa; and
- (c) recommend that customer due diligence measures when applied properly can be effective to fight money laundering in South Africa.

#### **1.5 Research question**

This research seeks to address the following question: Is customer due diligence an effective countermeasure against money laundering in South Africa?

#### **1.6 Rationale of the study**

Currently, money laundering has a negative impact on society, businesses and the South African economy. The current anti-money laundering initiatives rest on the idea

that the criminalisation and prosecution of money laundering crimes are not enough to fight money laundering in South Africa.<sup>24</sup>

The FIC Amendment Act brings to light the importance of employing administrative measures towards the fighting of money laundering.<sup>25</sup> These measures, *inter alia*, customer due diligence, assist financial organisations to know their customers and who they are doing business with. As a result, the control measures assist financial organisations to prevent, detect and prosecute any money laundering cases.

Numerous statutes regulate anti-money laundering measures used in the fight against money laundering in South Africa. Therefore, this research examines whether the measures implemented by the Amendment Act, specifically customer due diligence, is adequate to fight money laundering in South Africa.<sup>26</sup>

This research discusses the effectiveness of customer due diligence as regulated by the FIC Amendment Act.<sup>27</sup> Proposed recommendations to enhance the fighting of money laundering in South Africa are discussed. The researcher determines the effectiveness of relying on customer due diligence to fight money laundering in South Africa. This is done through a detailed analysis of customer due diligence as an anti-money laundering countermeasure.

## 1.7 Justification for the study

The regulation of customer due diligence measures in South Africa is not flawless. Stringent requirements for the identification and verification processes of financial customers by financial organisations have formed obstacles that prevent low income earners and the people from marginalised areas from accessing financial services such as bank accounts in South Africa.<sup>28</sup>

In this regard, it is necessary to slightly refer to the regulation of customer due diligence measures in the United Kingdom (UK) to isolate possible measures that can be adopted from the UK regulatory framework to enhance the combating of money

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<sup>24</sup> L De Koker and JJ Henning "Money Laundering Control in South Africa" 1998 *UOVS/UOFS Bloemfontein* 3.

<sup>25</sup> P Havenga et al *General Principles of Commercial Law* (6 ed 2007) Cape Town: Juta 381 - 382.

<sup>26</sup> Section 21 of the Financial Intelligence Amendment Act of 2017.

<sup>27</sup> Financial Intelligence Amendment Act of 2017.

<sup>28</sup> L De Koker "Money Laundering Control and Suppression of Financing of Terrorism: Some Thoughts on the Impact of Customer Due Diligence Measures on Financial Exclusion" 2006 *Journal of Financial Crime* 334-352.

laundering in South Africa. The UK has been referred to in the conclusion because it is regarded as having one of the best regulations of customer due diligence measures.<sup>29</sup> The UK as established a relatively adequate and effective regulatory framework on customer due diligence measures.

## 1.8 Literature review

The concept of customer due diligence has always had different views from an academic perspective. Numerous views have been brought forward regarding the effectiveness of customer due diligence in the fight against money laundering in South Africa. It has been reported that the incorporation and implementation of an internationally designed customer due diligence model in South Africa causes severe consequences like financial exclusion.<sup>30</sup>

Customer due diligence should be designed and implemented on a South African context-sensitive basis and not international standards. The verification requirements of customer due diligence as designed internationally are too rigid to the extent that the marginalised population of the country remains financially excluded.

Furthermore, in as much as the ongoing monitoring of transactions safeguards against money laundering,<sup>31</sup> it should be kept in mind that it has cost implications. Financial organisations should therefore focus on gathering quality rather than quantity information on their customers. This increases the chances of less resourceful customer due diligence but still adequate for the fighting of money laundering.

Technological evolution has made customer due diligence more efficient than ever. Effective anti-money laundering measures assist in preserving the reputation of a country by reducing the chances of its financial organisations becoming victims of money laundering.<sup>32</sup>

The researcher shows that it is adequate for a country to rely on customer due diligence in the fight against money laundering. It is stated that an integration of

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<sup>29</sup> Commonwealth Secretariat *Combating Money Laundering and Terrorist Financing: A Model of Best Practice for the Financial Sector, the Professions and other Designated Businesses* (2 ed 2006) Commonwealth Secretariat 138.

<sup>30</sup> L De Koker "Aligning Anti-Money Laundering, Combating of Financing of Terror and Financial Inclusion" 2011 *Journal of Financial Crime* 361, 365.

<sup>31</sup> Section 21C of the Financial Intelligence Centre Amendment Act of 2017.

<sup>32</sup> G Demetriades "Is the person who he claims to be?" Old Fashion Due Diligence May Give the Correct Answer!" 2016 *Journal of Money Laundering* 79, 82.

customer due diligence and the risk based approach is an effective application.<sup>33</sup> The risk based approach must be applied to determine potential money laundering risk involved.<sup>34</sup> Alerting the organisations on the potential risk assists them in exercising enhanced diligence when required which lessens the probability of any money laundering activities.<sup>35</sup> It can therefore be said that the reliance on customer due diligence to fight money laundering in South Africa can be adequate if financial organisations develop risk management compliance programmes.<sup>36</sup>

The reliance on customer due diligence to fight money laundering under the current anti-money laundering initiatives is achievable when implemented with the risk based approach.<sup>37</sup> Money laundering as a risk that requires the establishment of a framework for the realisation of a risk based approach on an ongoing basis.<sup>38</sup>

As much as customer due diligence is a significant anti-money laundering measure, it is still correct to say that the incorporation of the risk based approach to customer due diligence in the fight against money laundering improves the effect of customer due diligence. Risk based approach is applicable in every risk situation.<sup>39</sup> Money laundering is an international problem. It becomes credible to state that risk management and compliance programmes should be incorporated in all anti-money laundering measures to increase the effectiveness of the measures.

The reliance on customer due diligence as a countermeasure to fight money laundering in South Africa is adequate. However, it remains the task of this research to examine and analyse how the reliance on customer due diligence to fight money laundering can be achieved in South Africa.

## 1.9 Scope and limitations of the study

This research focuses on customer due diligence as a countermeasure against money laundering in South Africa. Other South African legislations that make provision of

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<sup>33</sup> Section 42 of the Financial Intelligence Centre Amendment Act of 2017.

<sup>34</sup> R Sharrock et al *Law of Banking and Payment in South Africa 2016* Cape Town: Juta 103.

<sup>35</sup> M Tuba and C Van Der Westhuizen "An Analysis of The 'Know Your Customer' Policy As an Effective Tool to Combat Money Laundering: Is it About Who or What to Know That Matters?" 2014 *International Journal of Public Law and Policy* 53, 55.

<sup>36</sup> Section 42 of the Financial Intelligence Centre Amendment Act of 2017.

<sup>37</sup> J Henning "Fortifying a Risk-Based Approach in the South African AML/CFT Process" 2017 *Journal of Financial Crime* 520, 521.

<sup>38</sup> J Henning "Fortifying a Risk-Based Approach in the South African AML/CFT Process" 2017 *Journal of Financial Crime* 522.

<sup>39</sup> N Magarura "Customer Due Diligence (COD) Mandate and the Propensity of its Application as a Global AML Paradigm" 2014 *Journal of Money Laundering Control* 77-93.

customer due diligence are referred to where necessary. However, this research mainly focuses on customer due diligence as an anti-money laundering measures in terms of the FICA and FIC Amendment Act. Moreover, for the purposes of this research, the term financial organisations is only used to refer to the organisations listed in the Amendment Act.

## **1.10 Overview of chapters**

In Chapter 2, I discuss what money laundering is by ascertaining the definitions of money laundering in its general context. I then pause to discuss the three-stage process pertaining to money laundering. Lastly, I touch on the content and scope of the above-mentioned implications of money laundering in South Africa. This discussion is important because money launderers often use front companies to launder money.

Also, depending on the extent of money laundering, financial markets may be susceptible to being fundamentally altered when criminal syndicates invest or withdraw money. Financial and non-financial organisations are major participants in assisting a country's economy to grow. Some of the financial organisations comprise of both national and international funds that assist countries in growing their economy.

It is unfortunate that money laundering hinders the growth of financial organisations. Some of the current anti-money laundering initiatives put in place in certain financial organisations reveal that there is a connection between money laundering and other dishonest crimes concluded by employees. Employees can use their workplace and other financial organisations to clean the funds. In other words, the funds are invested and deposited into other financial organisations so that the funds can appear to be from a legal person. This causes a serious effect on organisations because most of these transactions do not add up to those written in the organisation's financial books.

Chapter 3 commences with a discussion of the development of the risk-based approach. I then discuss selected statutes. Lastly, I touch on selected regulatory bodies. Fighting money laundering has called for the embedding of legislative reforms to ensure that South Africa is able to comply with the Financial Action Task Force's recommendations. Countermeasures are vital in fighting money laundering. They are

designed with the objective that financial organisations comply with legal requirements to quickly detect, prevent and reduce (potential) suspicious transactions.

Furthermore, in Chapter 4, I will begin by discussing the general context of customer due diligence. The definitions of customer due diligence are then ascertained. I will also discuss the risk-based approach. Thereafter, the effect of the risk-based approach will be assessed. I then pause to discuss how to perform customer due diligence. Lastly, I touch on the failure to perform customer due diligence. This discussion is important because customer due diligence is an effective tool in the battle to prevent money launders and other criminals from exploiting the wider financial system.

Therefore, conducting customer due diligence is a skill every anti-money laundering company analyst should have. A simple investigation into a (potential) suspicious transaction commences with conducting customer due diligence. In most countries with anti-money laundering frameworks, it is compulsory to conduct customer due diligence when establishing business relations with a potential customer.

Lastly, in Chapter 5, I will summarise the dissertation and provide a few recommendations. It is vital that the processes of customer due diligence adequately alleviate the dangers posed by customers' financial transactions. I emphasise that customer due diligence together with the legal enforcement and punishment are the most operative instruments against money laundering in South Africa.



## Chapter 2:

# Money laundering in South Africa

### 2.1 Introduction

It is evident that the development of technology has resulted in a rapid increase in the methods used by people who commit financial crime. This chapter explores some of the implications of money laundering in South Africa. The implications that I focus on are three, namely undermining of the legitimate private economy, the loss of control over economic policy and lastly undermining of the financial markets.

The structure of this chapter is as follows: the context of money laundering in general will first be discussed, after which the definition of money laundering will be ascertained. I then discuss the three-stage process pertaining to money laundering. Lastly, I touch on the content and scope of the above-mentioned implications of money laundering in South Africa.

### 2.2 What is money laundering?

#### 2.2.1 Context

Money laundering is a criminal activity that has been around for many years. The word was first invented by American legal authorities and became prevalent in the United States in the mid-1970s.<sup>40</sup> The origination of the word goes back to the usage of laundries as front organisations by American gangs in the 1920s and 1930s.<sup>41</sup> The laundries used to take their profits outside of America. This was because the government did not support commercial businesses.<sup>42</sup> The profit was reinvested in other businesses, which is still one of the methods used by people engaging in this criminal activity today.<sup>43</sup>

Money laundering is a means of hiding the identity of illegally obtained income so that it appears to have originated from legal sources. When illegal funds are derived

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<sup>40</sup> W Gilmore *Dirty money: The evolution of money laundering counter-measures* (4 ed 2011) Europe: Council of Europe Publishing 20.

<sup>41</sup> J Richards *Transnational criminal organizations, cybercrime and money laundering* (1998): New York: Routledge 43.

<sup>42</sup> <https://www.investopedia.com/terms/m/moneylaundering.asp> (accessed 20-07-2021).

<sup>43</sup> <https://www.investopedia.com/terms/m/moneylaundering.asp> (accessed 20-07-2021).

from robbery, fraud and so forth, a money laundering investigation is often the only way to detect the stolen moneys and restore them to the legal possessors.<sup>44</sup>

Also, detecting and preventing money laundering deprives the people engaging in crime of their illegally obtained funds. Without a usable profit, the criminal activity will not continue. The most harmful implication of money laundering schemes is that they place extensive amounts of money in the hands of criminals and allow them to put such money to further illegal use.

Moreover, recognition is the most crucial method in ensuring that money laundering is prevented. It is crucial for financial organisations to acknowledge those circumstances in which money laundering might happen. After all, regulations are only as efficient as their application.<sup>45</sup>

### 2.2.2 Definitions

Money that is not linked to any form of criminal activity or that has not been obtained from crime can be spent without any fear. Money laundering is commonly used to refer to financial transactions that aim to hide the identification of illegally obtained income. FICA describes money laundering as a process that has or is expected to have a consequence of disguising the essence, origin or whereabouts of the earnings of illegal activities any interest that any individual has in such earnings.<sup>46</sup>

The International Monetary Fund refers to money laundering as the processing of moneys produced through criminal activities to conceal the relation between the moneys and their illegal origin.<sup>47</sup>

Moreover, South African regulations expanded this definition to practically every action or transaction that includes the profits of a crime. This includes spending money that was obtained illegally. Money laundering therefore refers to any act that conceals the illegal origin, location or implementation of profits of crime.<sup>48</sup>

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<sup>44</sup> <https://www.interpol.int/en/Crimes/Financial-crime/Money-laundering> (accessed 20-07-2021).

<sup>45</sup> M Kersop "Anti-money laundering regulations and the effective use of mobile money in South Africa (2015) 18 *PELJ* 5.

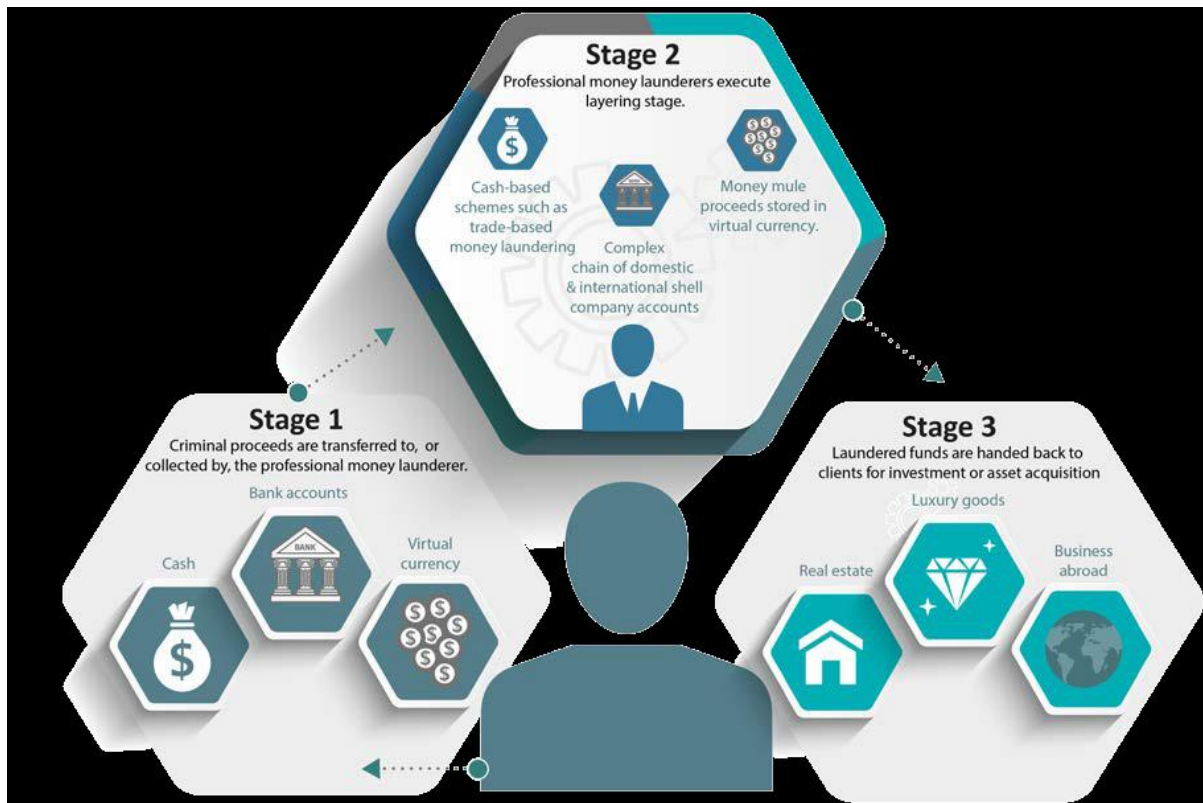
<sup>46</sup> Section 64 of the Financial Intelligence Centre Act 38 of 2001.

<sup>47</sup> <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/31/Fight-Against-Money-Laundering-the-Financing-of-Terrorism>.

<sup>48</sup> L De Koker, M Basson, P Smit and J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* 1.

## 2.3 A three-phase process

Money laundering is not one move but is a process that is completed in three stages. However, these stages can be completed at once using one transaction. They can also materialise in various structures (one by one). Traditionally, it has been acknowledged universally that the money laundering process consists of three core phases:



Three stages of professional money laundering  
2018 FATF Report

Firstly, placement is the process whereby the funds are transferred, electronically or physically, to the money launderer or to financial organisations acting on their behalf. The way in which the funds are placed into the money laundering conspiracy differs depending on the method in which the proceeds of crime were obtained, for example, cash or bank funds and so forth.<sup>49</sup>

It is at this phase where the proceeds of crime are placed into the financial organisation. Cash is easily deposited into a bank account where the money can be

<sup>49</sup> FATF *Professional money laundering* (2018) 18.

easily transferrable. An alternative way of placing the proceeds into the financial organisation is through the assistance of legal practitioners, accountants and so forth, using their trust accounts.<sup>50</sup>

People engaging in this activity ensure that they are not in physical possession of the funds as it can connect them to their criminal actions. The two aims of the money launderers are to remove the money from the source of achievement in order to avoid authorities detecting it and to immediately convert it into other forms of assets. An example includes postal orders.

Furthermore, there are numerous methods through which illegal funds can be entered into the financial structure. The most common methods include where businesses blend illegal funds with those obtained legally. This is done by using businesses such as car washes, as they have little or no variable costs.<sup>51</sup> Another method is carrying small amounts of cash overseas, which can then be paid into a foreign bank account before sending it back home.

Invoice fraud is also a common technique used by money launderers to transfer illegal money. It involves the under-invoicing and over-invoicing of goods and services, described and ghost shipping, which refers to fraudulent documents that have being produced to justify payments overseas where no items have been shipped.

Secondly, layering is the most complicated phase. It includes a difficult web of transactions to move around money into the financial system, usually through offshore techniques. The objective is to separate the proceeds of crime from the money launderer.<sup>52</sup> The majority of money launderers use account agreement tools to make it tough for legal authorities to trace the funds. A blend of different money laundering methods may be used as part of one conspiracy.<sup>53</sup> All of this is achieved by concealing the assessment trail through a sequence of strategic layering of financial transactions and bookkeeping tricks. The purpose of this stage is to conceal the original owners of the illegal funds.<sup>54</sup>

The second phase can be achieved in the following methods. The money is moved around electronically between different countries using loopholes in numerous

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<sup>50</sup> L De Koker, M Basson, P Smit and J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* ch 1.

<sup>51</sup> <https://calert.info/details.php?id=1239> (accessed 19-08-2021).

<sup>52</sup> L De Koker, M Basson, P Smit and J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* ch 1.

<sup>53</sup> FATF *Professional money laundering* (2018) 20.

<sup>54</sup> <https://calert.info/details.php?id=1239> (accessed 19-08-2021).

statutes. Moreover, the money can be converted into numerous financial instruments, such as bonds or shares. In some instances, people engaging in money laundering invest the money in a real estate company or any other shell company that has a functional front.

Lastly, the third phase of integration comprises of ingesting all the proceeds of crime into the economy. Once it has been accepted that the illegal funds have been placed and layered, the illegal funds will be integrated back into the legalised financial structure. Not only that but the proceeds are placed under the supervision of the money launderers, close associates or third parties as legal company funds.<sup>55</sup> The integration of the illegal funds is done by legal persons to create a reasonable explanation as to where the money comes from.

It is at this stage where it is difficult to distinguish whether the proceeds are legal or not. The money launderer is free to use the money as he pleases without getting caught. It is difficult to catch the money launderer if there are no documentation that can be used as evidence of the two aforementioned phases.

The third phase can be achieved in the following methods. The proceeds of crime can be invested in the real estate, luxurious goods, jewellery, overseas organisations or other highly-priced merchandises.<sup>56</sup> False invoices can also be created with an over-evaluation of the goods either imported into or exported out of a country.

## **2.4 Why should society care about money laundering?**

### **2.4.1 Impact on society**

Money laundering is a means by which criminals can obtain and enjoy the financial proceeds of their crimes. Without crime, there would be no funds to launder. There is a similar relationship between crime and victims. Victims can refer to an individual, entity, the government and so forth.

Advanced money laundering conspiracies require the assistance of professionals with bookkeeping, legal and financial expertise. This has resulted in a development of money laundering conspiracies in the late 20<sup>th</sup> century involving

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<sup>55</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 21 *LexisNexis* ch 1.

<sup>56</sup> FATF *Professional money laundering* (2018) 20.

individuals who assist money launderers to launder the proceeds of crime. Money laundering is a major contributor in undermining the civil society.<sup>57</sup>

Furthermore, detecting, preventing and reducing criminal activities do not happen easily or come cheap. The government needs to spend a lot of money on anti-money laundering initiatives. The result of this is that public spending reduces and people with small incomes suffer the most.

The social costs of money laundering are severe. The economic and political impact of criminal companies can diminish the social connection, moral principles and the self-governing organisations of society.

#### **2.4.2 Impact on businesses**

Criminals frequently use business undertakings and organisations to clean the proceeds of the crime. The business undertakings are done in both the formal and informal divisions of the South African economy. The businesses consist of partnerships, sole proprietorships, companies and so forth.<sup>58</sup>

Furthermore, front organisations are occasionally present in money laundering conspiracies and are used to open bank accounts. The main objective of these organisations is to provide the criminal with a commercial cover that he can use to conceal his identity and launder money. A family member or close association of the criminal is in most instances the shareholder or director of the organisation. He performs in accordance with the instructions of the beneficial owner of the organisation.<sup>59</sup>

Moreover, the proceeds of the crime are used to finance the business undertakings or mixed with the legal profits of the organisation and deposited into the organisation's bank account. Some of the organisations comprise of restaurants, bars and so forth.

Also, the integrity of financial markets relies on the viewpoint that it operates inside a structure of legal, professional and moral calibre. In fact, integrity is one of the most valued assets of a financial organisation.<sup>60</sup> If proceeds of crime can simply be

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<sup>57</sup> L De Koker, M Basson, P Smit and J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* ch 1.

<sup>58</sup> L De Koker, M Basson, P Smit and J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* ch 3.

<sup>59</sup> L De Koker, M Basson, P Smit & J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* ch 3.

<sup>60</sup> FATF Annual Report 2019-2020.

processed through a specific organisation – either because its personnel have been paid off or because the organisation overlooks the criminal origin of such proceeds – the organisation can be involved in a conspiracy with the criminals and become part of the criminal linkage themselves.

Furthermore, businesses that are laundering money have an unfair business advantage. This is because they can afford to sell a product at a cheaper price because their main goal is to clean the illegal money. This means that smaller businesses lose customers as they cannot compete.

Unfortunately, a money laundering scandal can create negative headlines for the business.<sup>61</sup> This negative publicity can result in customers losing trust in the business and taking their money or business elsewhere. Not only that but there are also serious consequences for businesses that are found guilty of laundering money or are associated with people, organisations or countries involved in the same criminal activity. Legal contracts entered into the parties can be lost and large financial penalties can be imposed.<sup>62</sup>

### **2.4.3 Impact on the economy**

Financial organisations are essential in assisting the economy to grow. Money laundering has a negative impact on the economy. It decreases productivity in the actual division of the economy. The sneaking in of laundered funds into legal financial organisations can jeopardise both economic and political balance.<sup>63</sup> Furthermore, financial crimes have a devastating impact on a country's economy seeing that victims of such crimes are far more than those in other crimes.

Financial crimes also have the possibility of negatively impacting people who do not at first sight seem to be the victims of the crime. For instance, tax evasion causes a decrease in the government's income. This in turn has an impact on the government's ability to spend on welfare projects and so forth.<sup>64</sup>

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<sup>61</sup> <https://www.infinitysolutions.com/blog/money-laundering-why-it-s-bad-for-society-business-and-the-economy/> (accessed 17-07-2021).

<sup>62</sup> <https://www.infinitysolutions.com/blog/money-laundering-why-it-s-bad-for-society-business-and-the-economy/> (accessed 17-07-2021).

<sup>63</sup> V Kumar "Money laundering: Concept, Significance and its impact" (2012) 2 *European Journal of Business and Management* 117.

<sup>64</sup> V Kumar "Money laundering: Concept, Significance and its impact" (2012) 2 *European Journal of Business and Management* 117.

Unfortunately, the impacts of money laundering on economic growth are difficult to measure, but it is clear that such activities harm financial organisations that are essential to develop the economy, decreases efficiency in the economy's division by averting assets and promoting crime, which slows down economic growth, and can change the economy's exterior division.<sup>65</sup>

## 2.5 Conclusion

Money laundering is a global issue and a diverse criminal activity. The implications of money laundering are not limited to the above-mentioned. The implications of money laundering are serious and far-reaching. The criminal activity can have a global, as well as domestic impact on businesses, economies and societies.

The dominance of casual commercial organisations in South Africa and the lack of official financial and commercial recordings permit the abuse of such organisations by launders.<sup>66</sup>

This criminal activity not only damages the financial sector organisations that are critical for economic growth, but it also encourages crime and corruption that reduces economic growth and affects the country's social well-being. As a result of the continuous development of technology, criminal activities can be restricted by appropriate countermeasures that detect illegal financial transactions at an early stage.

Money laundering is achieved by concluding several transactions that disguise illegal proceeds to appear as legitimate transactions or investments.<sup>67</sup> South Africa is not the only country that prohibits money laundering.

This chapter considered the definition of money laundering, how the process is conducted and some of the implications of this criminal activity is. In the next chapter, I will discuss select anti-money laundering initiatives in South Africa and globally.

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<sup>65</sup> V Kumar "Money laundering: Concept, Significance and its impact" (2012) 2 *European Journal of Business and Management* 117.

<sup>66</sup> *S v Dustigar* (Case no CC6/2000, Durban and Coast Local Division).

<sup>67</sup> D Millard and V Vergano "Hung Out to Dry? Attorney Client Confidentiality and the Reporting Duties Imposed by the Financial Intelligence Centre Act 38 of 2001" 2013 *Obiter* 389-427.



## Chapter 3:

# Anti-money laundering initiatives

### 3.1 Introduction

Numerous anti-money laundering laws have been enacted to combat money laundering in South Africa. Anti-money laundering initiatives are both a serious and effective element of anti-crime programs. Money laundering is a complicated and vibrant challenge throughout the world. The universal nature of money laundering requires both international standards and amplified international collaboration. This will assist in reducing the ability of criminals to launder their money.

The structure of this chapter is as follows. The development of the risk-based approach will be discussed first. I then discuss selected statutes. Lastly, I touch on selected international regulatory bodies.

### 3.2 Development of the risk-based approach (RBA)

When the initial set of Financial Action Task Force (FATF) principles were implemented in 1990. They were built around a rules-based approach. A rules-based approach provides that a supervisor must establish the rules to be implemented by regulatory organisations.<sup>68</sup> This approach is rigid as it provides detailed requirements on customer identification and due diligence that every organisation should apply. This approach offers the benefits of supervisory clarity, as long as the rules are developed with enough application.<sup>69</sup>

Unfortunately, the rules-based approach can be less resources-intensive for most organisations. The biggest disadvantage of the rules-based approach is the level of generality. All the customers are required to be subjected to systematised procedures. As a consequence, too much may be needed relating to lower risk customers while too little attention is given to customers with a higher risk.<sup>70</sup> The rules-

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<sup>68</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 117 *LexisNexis* 1.

<sup>69</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 117 *LexisNexis* 1.

<sup>70</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 117 *LexisNexis* 1.

based approach does not allow much room for flexibility for organisations to adjust when they encounter different risk levels.

On the other hand, the risk-based approach involves a transferal of duties for decisions relating to the applicable replies to evaluating money laundering risks from the regulator to the regulated organisation. While the regulator establishes the regulatory goals and guidelines, the way in which those goals must be accomplished and the guidelines applied by the organisation, is established by the organisation.

Moreover, numerous factors of the risk-based approach were slowly established into the FATF guidelines since 2003. This co-existed with the establishment of risk-based approaches to money allocation, administration and other standard setting equivalents of the FATF and the Basel Committee on Banking Supervision (BCBS). These changes led to the creation of risk management and commercial governance tasks of financial organisations.<sup>71</sup>

### **3.3 Selected statutes**

#### **3.3.1 Financial Intelligence Centre Act 38 of 2001 (FIC Act)**

The FIC Act requires accountable organisations to implement a risk-based approach when performing customer due diligence processes.<sup>72</sup> By implementing a risk-based approach, accountable organisations will be able to stop or fight money laundering and other financial crimes.<sup>73</sup>

A risk-based approach ensures that the biggest risks receive the most attention. The risk-based approach provides accountable organisations with the flexibility to use a variety of measures to authorise and verify the identities of their customers, making opportunities for accountable organisations to discover numerous new methods of providing financial facilities to a large number of customers whilst getting formerly disqualified parts of the community into the formal economy.<sup>74</sup>

An accountable organisation must at all times have reasons on which it can base its explanation for a decision that the correct balance was struck in a certain situation.

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<sup>71</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 117 *LexisNexis* 1.

<sup>72</sup> Financial Intelligence Centre Guidance Note 7 “On the implementation of various aspects of the Financial Intelligence Centre Act, 2001” 1-71 9.

<sup>73</sup> Financial Intelligence Centre Guidance Note 7 “On the implementation of various aspects of the Financial Intelligence Centre Act, 2001” 1-71 12.

<sup>74</sup> Financial Intelligence Centre Guidance Note 7 “On the implementation of various aspects of the Financial Intelligence Centre Act, 2001” 1-71 13.

The risk based approach is not a “zero failure” approach as there can be situations where an accountable organisation has taken all reasonable methods to establish and alleviate money laundering risk, but it is still misused for money laundering reasons.<sup>75</sup>

Organisations must use the customer due diligence measure as one of the methods to alleviate money laundering risk linked with a possible working relationship. This is one of the numerous measures at accountable organisations’ disposal to alleviate the risk of abuse for financial crime reasons.<sup>76</sup>

Before, accountable organisations were obligated to authorise and verify the identity of their customers according to the Money Laundering and Terrorist Financing Control (MLTFC) Regulations. The idea of customer identification and verification is now developed with the duty to perform customer due diligence. This, coupled with the duty to implement a risk-based approach, gives accountable organisations a discretion to establish the most suitable compliance measures to be carried out in certain situations.<sup>77</sup>

Some of the sections in the FIC Act relating to the principle of customer due diligence will be discussed briefly. Section 20A of the FIC Act provides that an accountable organisation cannot start a working relationship or conclude a deal with an unidentified customer or a customer with a fabricated name.<sup>78</sup> Section 21 of the FIC Act provides that a customer’s identity must be established and verified, according to the relevant organisation’s risk managing and conformity initiative, when an accountable organisation establishes a working relationship with a new customer.<sup>79</sup>

If an accountable organisation has created a working relationship with a customer before this Act was signed into law, the accountable organisation cannot complete a transaction amid that working relationship, except if the accountable organisation has taken the required action to authorise and verify the identity and to discover all financial records at that accountable organisation that are involved in transactions concluded amid that working relationship.<sup>80</sup>

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<sup>75</sup> Financial Intelligence Centre Guidance Note 7 “On the implementation of various aspects of the Financial Intelligence Centre Act, 2001” 1-71 25.

<sup>76</sup> Financial Intelligence Centre Guidance Note 7 “On the implementation of various aspects of the Financial Intelligence Centre Act, 2001” 1-71 26.

<sup>77</sup> Financial Intelligence Centre Guidance Note 7 “On the implementation of various aspects of the Financial Intelligence Centre Act, 2001” 1-71 28.

<sup>78</sup> Section 20A of Financial Intelligence Centre Act 38 of 2001.

<sup>79</sup> W Spruyt “A legal analysis of the duty on banks to comply with targeted financial sanctions” 2020 *TSAR* 29.

<sup>80</sup> Section 21 of Financial Intelligence Centre Act 38 of 2001.

Section 21A of the FIC Act requires an accountable organisation to determine from a potential customer what the essence and proposed reason of the working relationship will be, as well as to get information on the source of the money that the potential customer anticipates using amid the working relationship. In most situations, the essence and proposed reason for the working relationship will be clear given the essence of the goods or services that the customer is seeking.<sup>81</sup>

Section 21B of the FIC Act states that if a customer envisaged in section 21 is a legal individual or a natural individual acting on behalf of a partnership or trust, an accountable organisation must also authorise the essence of the customer's business; the ownership and control structure of the customer; and the identity of the beneficial owner.<sup>82</sup>

Sections 21F, 21G and 21H of the FIC Act deal with individuals in important positions. Working relationships with local important individuals are not considered high risk. However, working relationships with foreign important civil servants will always be considered high risk.<sup>83</sup>

Section 42 of the FIC Act 38 of 2001 provides a comprehensive outline of compliance duties which accountable organisations must address in their required Risk Management and Compliance Programme (RMCP).<sup>84</sup> The requirements correlate to the developing, reporting, preserving and implementation of an initiative for anti-money laundering and other financial crimes risk managing and compliance.

### **3.3.2 Financial Intelligence Centre Amendment Act of 2017 (FIC Amendment Act)**

The amendments introduced by this Act provided new methods and changed the current principles and exceptions in the FICA. They also changed the compliance methods used by accountable organisations.<sup>85</sup> The amendments are intended to reinforce the South African monitoring structure for money laundering and other financial crimes.

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<sup>81</sup> Section 21A of Financial Intelligence Centre Act 38 of 2001.

<sup>82</sup> Section 21B of Financial Intelligence Centre Act 38 of 2001.

<sup>83</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-71 49.

<sup>84</sup> L De Koker, M Basson, P Smit and J Symington "The combating of money laundering, financing of terrorism and proliferation financing" (2019) 21 *LexisNexis* 1.

<sup>85</sup> W Spruyt *The Financial Intelligence Centre Amendment Act and the application of a risk-based approach* (2017) 1-31 19.

Also, they ensure that that South African structure is now in line with the 40 Recommendations provided by the FATF. Even though the scope of the amendments is extensive, most of the amendments relate to customer due diligence (CDD). The aim of CDD is for accountable organisations to know who their customers are and to understand the work that the customers are doing with the organisation.<sup>86</sup> This comprehension is done by using client identification and verification processes.

CDD now requires the identification of beneficial owners. The requirement ensures that individuals do not abuse corporations with the aim of committing financial crimes. The requirement links to working relationships with foreign important civil servants and local powerful individuals to make sure that accountable organisations apprehend the origin and possible risk created by their customers.<sup>87</sup>

The amendments were also made to comply with the United Nations Security Council Resolutions that deal with the freezing of possessions belonging to an individual linked to terrorism.<sup>88</sup> It also requires the safekeeping of personal details aligned with the prerequisites of the Protection of Personal Information Act (POPIA).<sup>89</sup>

The risk-based approach symbolises the opposite of the rules-based approach. The risk-based approach allows an accountable organisation to make risk informed judgements relating to the running of its unique risks. It is important to keep in mind that the risk-based approach does not discharge accountable organisations from alleviating money laundering risks by complying with the CDD requirements where the risk was classified as being low.<sup>90</sup>

## **3.4 Selected regulatory bodies**

### **3.4.1 Financial Action Task Force (FATF) 2012**

The risk-based approach is vital to the effective application of the reviewed FATF *International Standards on Combating money Laundering and the Financing of Terrorism and Proliferation*, which was implemented in 2012.<sup>91</sup>

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<sup>86</sup> Recommendation 10 Financial Action Task Force (2012).

<sup>87</sup> Section 21F and section 21G of the Financial Intelligence Centre Act 38 of 2001.

<sup>88</sup> Section 26A of the Financial Intelligence Centre Act 38 of 2001.

<sup>89</sup> Section 13 of the Protection of Personal Information Act 4 of 2003.

<sup>90</sup> W Spruyt *The Financial Intelligence Centre Amendment Act and the application of a risk-based approach* (2017) 21.

<sup>91</sup> Financial Action Task Force (2012).

In 2012, the FATF updated its Recommendations to toughen international principles and to safeguard the honesty of the financial structure by giving governments resilient tools to use when taking action against financial crimes.<sup>92</sup>

One of the vital changes was the amplified significance on the risk-based approach to money laundering, especially relating to preventative processes and supervision. The 2003 Recommendations provided for the implementation of a risk-based approach in some areas, while the 2012 Recommendations regard the risk-based approach to be an important basis of a country's anti-money laundering structure.<sup>93</sup>

In accordance with the 40 Recommendations, the risk-based approach permits countries to accept a flexible range of methods in order to target their assets more efficiently and implement defensive methods that are appropriate to the nature of the risk in the most efficient manner. Implementation of the risk-based approach is a requirement for the efficient application of the FATF principles.

Furthermore, Recommendation 1 provides the scope of the implementation of the risk-based approach. It relates to who and what must be subject to a nation's anti-money laundering system, and how those subject to the anti-money laundering system must be supervised for obedience to this system. Also, it sets out how those subject to the anti-money laundering system must conform.<sup>94</sup> Moreover, an efficient risk-based approach system mirrors a country's legitimate and supervisory methodology and its risk profile. Where the risks are high, financial systems are advised to implement enhanced due diligence.<sup>95</sup>

Recommendation 10 provides that financial organisations may not be allowed to have unidentified accounts or accounts in false names. The principle that financial organisations must perform customer due diligence must be provided for in law. If for any reason, a financial organisation is unable to conduct customer due diligence, it must not establish a new working relationship and must terminate its current working relationship with the said customer or organisation.<sup>96</sup>

Recommendation 26 obligates countries to subject banks to adequate anti-money laundering regulation and supervision. Superiors must provide assets to

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<sup>92</sup> FATF *Guidance for a risk-based approach: The bank sector* (2014) 1-50 8.

<sup>93</sup> FATF *Guidance for a risk-based approach: The bank sector* (2014) 1-50 8.

<sup>94</sup> Recommendation 10 Financial Action Task Force (2012).

<sup>95</sup> FATF *Guidance for a risk-based approach: The bank sector* (2014) 1-50 8.

<sup>96</sup> Recommendation 12 Financial Action Task Force (2012).

aspects with higher money laundering risk, on condition that the superiors understand the money laundering risk.<sup>97</sup>

### 3.4.2 Basel Committee on Banking Supervision (BCBS) Guidelines 2017

The Committee has a well-established devotion to uphold the application of sound anti-money laundering guidelines that are essential in safeguarding the wellbeing and accuracy of banks and the integrity of the international financial structure.

The Committee supports the implementation of the principles provided by the FATF. The Committee's commitment to fighting money laundering is in line with its directive to toughen the regulation, management and policies of banks with the aim of improving financial security.<sup>98</sup>

Financial organisations must improve and apply clear customer acceptance guidelines to assist in identifying the kind of customer that is likely to create a higher risk of money laundering. When evaluating the risk, a financial organisation must take into consideration the elements applicable to the circumstances. The elements include the customer's background, occupation, origin of income, country of birth and so forth.<sup>99</sup>

The above rules demand simple due diligence for all customers and appropriate due diligence according to the level of risk linked with the customer. For low-risk circumstances, simplified due diligence is sufficient. In situations where the risk is higher, financial organisations must exercise enhanced due diligence to alleviate and control those risks. Enhanced due diligence is obligatory for people who anticipate retaining a large account balance.

Furthermore, the identity of all customers, beneficial owners and people acting on their behalf must be identified and verified by using authentic and self-supporting information. The best documents for the identification and verification of customer's identities are those that are difficult to get illegally or cannot be forged. This information is used to create a customer's profile. Therefore, it is important that the information be relevant and correct.

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<sup>97</sup> Recommendation 12 Financial Action Task Force (2012).

<sup>98</sup> Basel Committee on Banking Supervision *Guidelines Sound management of risks related to money laundering and financing of terrorism* (2017) 1-47 1.

<sup>99</sup> Basel Committee on Banking Supervision *Guidelines Sound management of risks related to money laundering and financing of terrorism* (2017) 1-47 7.

### 3.5 Conclusion

Client identification and verification are the foundations of the anti-money laundering system. Even though the amendments to the FIC Act have recently come into effect, it is clear that the introduction of the risk-based approach into the South African anti-money laundering supervisory structure will have important consequences for the administration of money laundering risk and compliance with the FIC Act requirements.

It is important that accountable organisations create and apply a risk-based approach that helps them understand their customers, their relations with their customers, the risk level created by these relationships, and the risks posed by their organisations.<sup>100</sup>

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<sup>100</sup> W Spruyt *The Financial Intelligence Centre Amendment Act and the application of a risk-based approach* (2017) 1-31 30.



## Chapter 4:

# Customer due diligence as a countermeasure

### 4.1 Introduction

Financial institutions process millions of financial transactions daily, so it is essential for an institution to know its clients. Customer due diligence entails the collation of information about customers to assist in assessing the extent of any risk that they pose to the institution. In some jurisdictions like the UK the concept of customer identification and verification is referred to as the know-your-customer policy.<sup>101</sup>

This does not simply refer to one taking a copy of a customer's identification document to prove the client's identify. It means analysing the customer's profile from the inception of the relationship to recognising key changes overtime and undertaking regular reviews. It makes business sense to understand a customer, as you ensure that their needs are responded to. However, it is also an effective tool in preventing and detecting money laundering and other financial crimes that aim to exploit financial institutions.

The structure of this chapter is as follows. Customer due diligence in general will be discussed first, as well as the definitions of customer due diligence. I then discuss the essentials of customer due diligence and the circumstances under which customer due diligence is required. Thereafter, I assess the risk-based approach and lastly, I discuss the manner in which customer due diligence is performed.

### 4.2 Customer due diligence (CDD) in general

#### 4.2.1 Context

Financial organisations must advance and apply measures to alleviate the money laundering risks they have detected through their risk evaluations. CDD mechanisms must be designed to assist financial organisations apprehend who their customers are by obliging them to provide details on their profession and the reason why they want to establish a business relationship with the organisation.<sup>102</sup>

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<sup>101</sup> P Havenga et al *General Principles of Commercial Law* (6 ed 2007) Cape Town: Juta 381.

<sup>102</sup> FATF *Guidance for a risk-based approach: The bank sector* (2014).

Moreover, the preliminary phases of the CDD procedure must be aimed to assist financial organisations evaluate the risk linked with an anticipated business relationship, govern the degree of CDD to be implemented and discourage individuals from creating a work relationship to perform illegal undertakings.<sup>103</sup>

Financial organisations must ensure that they are capable of developing a customer risk outline. Knowing how to create a customer profile assists organisations to identify the degree of risk they are faced with and which method of ongoing monitoring to apply.

CDD measures, if correctly applied, enable an accountable organisation to better manage its relationships with customers and to identify potential efforts by customers to misuse the organisation's products and services for illegitimate reasons. Demanding responsible institutions to apply CDD is crucial in fighting money laundering and other financial crimes effectively.<sup>104</sup> CDD allows one and one's institution to assess the risks pertaining to money laundering and other financial crime that a client, and the work they want you to undertake, may expose you to.<sup>105</sup>

#### **4.2.2 Definitions**

Customer due diligence is a preventative measure in terms of the FATF Recommendations and South African legislation. The FATF defines CDD as identifying one's customer and verifying that customer's identity using reliable, independent source documents, data or information.<sup>106</sup> CDD refers to the information that a responsible organisation has regarding its customer and the organisation's interpretation of the work with which the customer is involved.

Customer due diligence refers to a regular investigation procedure of a customer's background that is conducted by financial organisations before signing commercial agreements with a new customer.<sup>107</sup> Customer due diligence is aimed at assessing the potential risk that may exist between the financial organisation and the

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<sup>103</sup> FATF *Guidance for a risk-based approach The bank sector* (2014).

<sup>104</sup> [https://www.fic.gov.za/Documents/171002\\_FIC%20Guidance%20Note%2007.pdf](https://www.fic.gov.za/Documents/171002_FIC%20Guidance%20Note%2007.pdf) (accessed 19-09-2021).

<sup>105</sup> <https://sanctionscanner.com/knowledge-base/customer-due-diligence-cdd-15> (accessed 19-09-2021).

<sup>106</sup> <http://www.fatf-gafi.org/recommendations> (accessed 30-06-2021).

<sup>107</sup> L Ai and T Jun "The International Standards of Customer Due Diligence and Chinese Practice" 2009 *Journal of Money Laundering Control* 406, 407.

customer.<sup>108</sup> Due refers to something that is expected by the relevant authorities.<sup>109</sup> Diligence refers to a vigilant and methodical work or exertion by a financial organisation. Swift, a global provider of secure financial messaging services, defines CDD as the procedures utilised by financial organisations to gather and assess data regarding a potential customer. The objective is to detect any possible danger to the financial organisation of doing work with a specific organisation or person by scanning data from a diversity of origins.<sup>110</sup>

In simple terms, CDD refers to a regular investigation of a customer's background that is conducted by institutions before entering into new agreements with new customers.<sup>111</sup> One is in a much better position to detect potential money laundering if one knows who one's customers are and understand the reasoning behind the mandate that they have given one.

### 4.3 The risk-based approach (RBA)

The risk-based approach requires the implementation of risk managing resources, controls and extra preventive methods that are appropriate to the risk being managed. Higher areas of risk should therefore be the focus of higher inspection and control, with fewer harsh principles being applied to parts of lower risk.<sup>112</sup>

When looking at things from a customer due diligence view, the risk-based approach requires that an accountable organisation's due diligence requirements must originate from the risk created by a certain customer relationship.

Where the risk is higher, the customer identification and verification demands must be harsher and more comprehensive. This confirms that the organisation makes a truthful customer profile. A higher risk requires ongoing due diligence. This means demanding that the customer's information be updated more regularly and that the customer's behaviour be observed more.

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<sup>108</sup> L Ai and T Jun "The International Standards of Customer Due Diligence and Chinese Practice" 2009 *Journal of Money Laundering Control* 406, 407.

<sup>109</sup> Hornby AS Oxford Advanced Learner's Dictionary of Current English (7 ed 2005) *Oxford University* 474.

<sup>110</sup> <https://www.swift.com/your-needs/financial-crime-cyber-security/know-your-customer-kyc/customer-due-diligence-cdd> (accessed 19-09-2021).

<sup>111</sup> S Munedzi *The reliance of customer due diligence to enhance the combating of money laundering under the Financial Intelligence Centre Amendment Act 1 of 2017* (2019) LLM, North West University.

<sup>112</sup> W Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1-34 27.

Where the risk is lower, fewer difficult identification and verification demands are implemented. Also, the customer's behaviour will not be closely observed. Essential to the implementation of a risk-based approach to customer due diligence is the correct evaluation of the risk that a customer relationship creates.<sup>113</sup>

Customers that use goods and services that are possibly used to commit money laundering and other financial crimes can be linked with having a higher risk. Transactional funding goods can be used to ease the placing of illegal money into the financial scheme and the layering of such money to hide the source thereof.

Usually, non-face-to-face communication is viewed as higher risk because it is more difficult to confirm the customer's identity. There are specific individuals that are automatically linked with a high risk. This includes politically exposed individuals.<sup>114</sup>

As already discussed, one of the most important changes introduced by the risk-based approach is the transparency of beneficial ownership of legal individuals. Countries must take extra methods to stop the abuse of legal individuals for money laundering purposes. Financial organisations must guarantee that there is enough, correct and relevant information on the beneficial ownership and control of legal individuals.<sup>115</sup>

## **4.4 Effect of the risk-based approach**

### **4.4.1 Creation of a Risk Management and Compliance Programme (RMCP)**

The initial set of requirements are provided in section 42 of the FIC Act as stipulated in the previous chapter. The FIC Act states the following. The Risk Management and Compliance Programme (RMCP) must state how an accountable organisation implements a risk-based approach, obeys with the requirements in the FIC Act and efficiently controls its money laundering and other financial crime risks.<sup>116</sup>

The RMCP is the basis of an accountable organisation's obedience to the demands and duties stated in the FIC Act. An RMCP is a collection of documents

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<sup>113</sup> W Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1-34 27.

<sup>114</sup> W Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1-34 27.

<sup>115</sup> Recommendation 24 Financial Action Task Force (2012).

<sup>116</sup> W Spruyt *The Financial Intelligence Centre Amendment Act and the application of a risk-based approach* (2017) 28.

including methods, processes, policies used for anti-money laundering and other financial crime risk management and compliance reasons.

An RMCP must permit an accountable organisation to efficiently implement a risk-based approach and meets the regulatory demands. The aim of an RMCP is to permit an accountable organisation to identify, evaluate, monitor, alleviate and control money laundering and other financial crime risks by way of both obedience and dynamic risk management.<sup>117</sup>

An RMCP must include the improvement of measures to control and alleviate the risk that the provision of goods or facilities may pose or enable money laundering and other financial related crimes. An RMCP must address the intimidations and weaknesses that may result to an accountable organisation being incapable of noticing the misuse of its goods or facilities for the purpose of committing financial crimes.

An RMCP must include processes that tell the board and senior management of all the anti-money laundering initiatives, deficits and remedial action taken. An RMCP must create numerous commissions and oversight organisations to govern, supervise and direct an accountable organisation's determinations in relation to the efficient application of an RMCP.

It is clear that the development of an RMCP cannot be done without a risk-based approach. In fact, the extent and content of the RMCP is based on applying a risk-based approach.<sup>118</sup>

#### **4.4.2 Scope of customer due diligence**

The CDC requirements and processes aim to ensure that an accountable organisation knows and understands its customers. This information helps an accountable organisation detect unusual activities that does not align with the organisation's knowledge of that customer's identity.

The risk-based approach allows accountable organisations to exercise discretion when applying the applicable due diligence measure to meet these objectives.<sup>119</sup> The risk based approach can provide the scope and essence of information required to authorise the identity of a customer,<sup>120</sup> the essence and reason for the working

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<sup>117</sup> Section 42(2)(a) of the Financial Intelligence Centre Act 38 of 2001.

<sup>118</sup> Section 42(2B), read with Section 42A of the Financial Intelligence Centre Act 38 of 2001.

<sup>119</sup> W Spruyt *The Financial Intelligence Centre Amendment Act and the application of a risk-based approach* (2017) 29.

<sup>120</sup> Section 21 of the Financial Intelligence Centre Act 38 of 2001.

relationship,<sup>121</sup> and the customer's source of income.<sup>122</sup> Even though it is common that the basic characteristics will always be used in an accountable organisation's procedures to authorise a customer's identity, the accountable organisations have a bigger discretion to require additional information that they deem relevant.<sup>123</sup>

The risk-based approach can state which information must be verified and which applicable verification measures must be implemented.<sup>124</sup> In most situations, verification measures depend on the type of information used to authorise a customer's identity. Accountable organisations are allowed to choose from a variety of measures to authorise and verify customers' information.<sup>125</sup>

## **4.5 How to perform customer due diligence**

Customer due diligence is a significant aspect of handling the risk that an institution may face in terms of the risk-based approach. A risk rating helps an institution in deciding how and when to apply the appropriate checks and controls that correspond to the level of risk. The steps are discussed below.

### **4.5.1 Data collection**

The first step is to make sure that you establish the complete identity and business operations of your potential customer before entering into a business relationship with them. This gives you the opportunity to screen the potential customer early on.

The general information collected includes the customer's full name, residential address, email address, contact numbers, place of birth, date of birth, gender, marital status, nationality, race, identification number and parental or guardian's consent in circumstances where the customer is a minor.

Furthermore, as a service provider you need to thoroughly understand why a customer wants to establish a business relationship with your company. Usually, the customer requires the services that your company offers.<sup>126</sup> In order to understand the

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<sup>121</sup> Section 21A of the Financial Intelligence Centre Act 38 of 2001.

<sup>122</sup> Section 21A of the Financial Intelligence Centre Act 38 of 2001.

<sup>123</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 87.

<sup>124</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1- 90 88.

<sup>125</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-79 31.

<sup>126</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-29 7.

purpose and nature of the business relationship, you need to obtain the following information: information of the customer's employment or their business; the nature and purpose of the relationships between the company, customer, and primary beneficial owners and the nature of transactions that are going to be executed by your business for the client during the business relationship.

A deeper understanding of why someone wants to become your customer is critical in detecting any suspicious activities throughout the business relationship. Moreover, understanding the intended nature of the business relationship is connected to the monitoring requirement.

#### **4.5.2 Independent verification of collection**

Collecting information about a potential customer is not sufficient. Financial organisations must guarantee that processes are put in place to verify the information collected from the customer to ensure accuracy and legitimacy of the data. Verification of information includes requesting supporting documents from the customer and ensuring that the same documents reflect the information that the customer has provided to the financial organisation.

While financial organisations are obligated to identify its customers and verify their identities, the source and extent of the information that must be verified will depend on the risk evaluation.<sup>127</sup> In circumstances where an account has been opened but issues of verification arise amid the establishment of the working relationship that cannot be rectified, the financial organisation must close or stop all access to the account.<sup>128</sup>

#### **4.5.3 Name screening**

An accountable organisation should inspect its customer's documentations to find out whether the customer has any other working relationship with any individual or organisation.<sup>129</sup> Even though the duty to inspect customers' documentations will happen when a declaration is made, banks are required to screen their customers on

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<sup>127</sup> Basel Committee on Banking Supervision Guidelines Sound management of risks related to money laundering and financing of terrorism (2017).

<sup>128</sup> Basel Committee on Banking Supervision Guidelines Sound management of risks related to money laundering and financing of terrorism (2017).

<sup>129</sup> Section 25 of the Protection of Constitutional Democracy against Terrorist and Related Activities Act 2004.

a regular basis. Screening must be done whenever an accountable organisation takes on new customers.<sup>130</sup> This will assist accountable organisations to establish the amount and types of resources required to establish whether they have sanctioned customers or organisations as customers.

Unfortunately, accountable organisations that have working relationships with foreign individuals or organisations are more exposed to doing business with sanctioned individuals or organisations.<sup>131</sup>

#### **4.5.4 Decision outcome**

A skilled individual with numerous years of financial experience may then provide suggestions to summarise the customer's risk level to the institution and recommend specific controls after establishing a business relationship with the customer. If necessary, depending on the level of risk, one can decide not to establish a business relationship with the customer.

Unfortunately, choosing not to establish a business relationship with the customer may in specific circumstances be counterproductive. Therefore, it is important that one does not de-risk a fragment of customers, thereby compelling them to resort to unfettered and illegal sources for their financial needs.

#### **4.5.5 Ongoing monitoring**

Section 21C of the FIC Act deals with ongoing due diligence processes. It demands that accountable organisations guarantee that the information that an accountable organisation has about a customer is still correct and relevant. The aim of the ongoing processes is to establish the activities of customers amid the working relationship which are not in line with the accountable organisation's knowledge of the customer.<sup>132</sup>

Ongoing monitoring refers to the inspection of customers and undertakings to see whether they are the same as the organisation's information of the customer and the origin and objective of the working relationship. Monitoring also comprises

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<sup>130</sup> W Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1-34 22.

<sup>131</sup> W Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1-34 22.

<sup>132</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-71 46.



identifying alterations to the customer profile and keeping their information up to date. Ongoing monitoring may require the implementation of new CDD mechanisms.<sup>133</sup>

Furthermore, ongoing monitoring plays a vital role in the effectiveness of anti-money laundering mechanisms. Financial organisations can mitigate risks if it is aware of its customer's financial undertakings. This will assist financial organisations to detect and prevent suspicious undertakings that are taking place behinds closed doors. Without the above knowledge, financial organisations will not be able to detect and prevent suspicious undertakings.<sup>134</sup>

Ongoing monitoring must be done in all working relationships and undertakings, but must be done based on the risks identified in the organisation. The FATF requires that ongoing monitoring be conducted regularly on foreign nations and their organisations. Enhanced monitoring must be conducted on high-risk customers and undertakings.<sup>135</sup> Financial organisations must implement systems that are able to detect any suspicious undertakings. A customer's risk profile is developed using the information collected during the CDD process.<sup>136</sup> Monitoring must be done on a continuous basis.

#### 4.5.6 Record keeping

Section 22 of the FIC Act states that when an accountable organisation is required to get information relating to a customer or potential customer, the organisation must keep paper trails of that information. The records must consist of duplicates of information received by the accountable organisation.<sup>137</sup>

Financial organisations must provide clear guidelines on the kind of documents that must be kept. The guidelines must define the category of information and documents to be recorded and stipulate how long such information and documents must be kept. It is recommended that organisations retain the above information for at least 5 years after the working relationship has ended.<sup>138</sup>

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<sup>133</sup> FATF *Guidance for a risk-based approach The bank sector* (2014).

<sup>134</sup> Basel Committee on Banking Supervision *Guidelines Sound management of risks related to money laundering and financing of terrorism* (2017).

<sup>135</sup> FATF *Guidance for a risk-based approach The bank sector* (2014).

<sup>136</sup> Basel Committee on Banking Supervision *Guidelines Sound management of risks related to money laundering and financing of terrorism* (2017).

<sup>137</sup> Section 22 of Financial Intelligence Centre Act 38 of 2001.

<sup>138</sup> Basel Committee on Banking Supervision *Guidelines Sound management of risks related to money laundering and financing of terrorism* (2017).

Preserving complete and simplified records is vital for a financial organisation to effectively monitor its relationship with its customer, to comprehend the customer's ongoing business and undertakings, and to make available an audit trace in the occurrence of investigations that might end up in criminal action.<sup>139</sup>

Moreover, efficient record-keeping of documents explaining the assessment procedure related to ongoing monitoring must also be recorded. This will assist in indicating financial organisations' compliance with the CDD requirements and its capability to manage and alleviate financial crimes. Not only that but, an accountable organisation must keep a record of every single transaction whether the transaction was a once off or was completed amid the working relationship which that accountable organisation has with that customer.<sup>140</sup>

Recommendation 11 of the FATF Recommendations provides that financial organisations must retain, for a minimum of at least five years, all the required accounts on transactions, both local and international, to allow them to obey with information demands from the experienced authorities.<sup>141</sup>

#### **4.6 Failure to perform customer due diligence**

Section 21E of the FIC Act forbids accountable organisations from creating or continuing working relationships or completing transactions if they are unable to perform the required CDD according to the provisions of the Act. Accountable organisations are obligated to take a neutral approach when deciding what constitutes a failure to perform CDD in any situation. There can be situations where it is sensible to delay terminating a working relationship while the organisation enables the customer's attempts to fix the failure. The sensibility of the delay will depend on the facts of each case.<sup>142</sup>

Where a customer refuses to produce the required documentation, the working relationship must be terminated once the customer has been told of the possible consequences and given time to answer accordingly. Accountable organisations must

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<sup>139</sup> Basel Committee on Banking Supervision Guidelines Sound management of risks related to money laundering and financing of terrorism (2017).

<sup>140</sup> Section 22A of Financial Intelligence Centre Act 38 of 2001.

<sup>141</sup> Recommendation 12 Financial Action Task Force (2012).

<sup>142</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-71 47.

consider whether the situations that stop them from performing CDD are suspicious or uncommon as required in section 29 of the FIC Act.

The number of efforts to get the required information or to implement another CDD process must be stated in an accountable organisation's RMCP. An accountable organisation's RMCP must state the methods through which it will terminate a current working relationship when it is not able to comply with the CDD requirements.<sup>143</sup>

#### **4.7 Conclusion**

The risk-based approach shows us that the standard of due diligence applied to customers is not the same. This means that not all customers must be treated the same from a customer identification and verification viewpoint.<sup>144</sup> Not only that but, an accountable organisation can take an informed judgment on the basis of its risk evaluation as to the appropriate measures and stages of verification that must be implemented in a situation. This structure must be part of the accountable organisation's core processes to address money laundering and other financial crimes.<sup>145</sup> An accountable organisation that does not meet the requirement of conducting customer due diligence processes is put through an administrative sanction.<sup>146</sup>

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<sup>143</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-71 47.

<sup>144</sup> W Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1-34 33.

<sup>145</sup> Financial Intelligence Centre Guidance Note 3A "Guidance for accountable institutions on client identification and verification related matters" 1-8 4.

<sup>146</sup> Section 46A of Financial Intelligence Centre Act 38 of 2001.

## Chapter 5:

# Conclusion and recommendations

South Africa prides itself on being obedient with international principles. Thus, its financial governing structure draws much from the recommendations of the FATF. The changes brought by the FIC Amendment Act formally introduced the customer due diligence concept into the South African legislative structure. The amendments introduced a risk-based approach and removed the rules-based approach. The move from a rules-based approach to a risk-based approach has a distinctive effect on client identification and verification.<sup>147</sup>

With the introduction of the risk-based approach, accountable institutions are required to create appropriate customer due diligence processes to alleviate money laundering risks they recognised and evaluated and record these in their RMCPs. The risk-based approach is also associated to the development of digital identity.<sup>148</sup>

In interpretation of the mainly principles-driven anti-money laundering structure in South Africa, an implementation of the FATF guidance and clear link with innovation and financial inclusion policies of the government will serve to promote changes in the digital customer due diligence context.

While the rules-based approach was revoked and organisations now enjoy more flexibility, some principles and prescriptions have remained in place. The risk-based approach is incomplete. Some categories of customers with high risk are subject to enhanced customer due diligence processes. Some of these cannot be simplified even if they may carry a lower risk.<sup>149</sup>

Accountable organisations must be aware of the volatility of money laundering risk and hence the need to amend customer due diligence processes over the course of a working relationship. It is important that accountable organisations promote a suitable and reliable understanding of the introduction of beneficial ownership across its organisation, compliance and internal audit duties.

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<sup>147</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 143 *LexisNexis* 1

<sup>148</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 143 *LexisNexis* 1

<sup>149</sup> L De Koker, M Basson, P Smit and J Symington “The combating of money laundering, financing of terrorism and proliferation financing” (2019) 144 *LexisNexis* 1

No sum of resources or preventive methods can totally guarantee that the financial system is not misused for the aim of committing financial crimes. However, non-compliance with the customer due diligence requirements can have a set of results, including criminal and regulatory consequences.

Accountable organisations in South Africa and operating in jurisdictions outside of South Africa must be attentive of local anti-money laundry duties in all the jurisdictions where they work. Accountable organisations must assess their customer due diligence measures on a regular basis to ensure that they stay applicable to the organisation's operation and the risks identified.<sup>150</sup>

The United Kingdom's principles have two parts, which if applied in South Africa, can be very useful. Firstly, according to the Fourth Money Laundering Regulation of the European Union, member states are obligated to introduce an essential register of beneficial ownership of legal bodies integrated in that jurisdiction. The UK's openly accessible register is currently active. Determining beneficial owners can be very difficult in South Africa.<sup>151</sup>

Secondly, the United Kingdom's principles state that where applicable to the size and essence of the business, organisations must evaluate the skills, knowledge, behaviour and reliability of those workers who are involved in identifying, alleviating, stopping or spotting money laundering and other financial crimes. This requirement is likely to have momentous beneficial results relating to skills development, proficiency and specialisation in the compliance business which we need in South Africa.

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<sup>150</sup> Financial Intelligence Centre Guidance Note 7 "On the implementation of various aspects of the Financial Intelligence Centre Act, 2001" 1-71 64.

<sup>151</sup> C Hugh & W Spruyt Money laundering, terrorist financing and financial sanctions: South Africa's response by means of the Financial Intelligence Centre Amendment Act 1 of 2017" (2018) *TSAR* 227-260 255.

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