THE ROLE OF CORPORATE GOVERNANCE IN REDUCING ILLICIT FINANCIAL OUTFLOWS IN SOUTH AFRICA

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DECLARATION

I declare that this report is my own, unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Laws in the field of Company law at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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In the name of Allah (SWT) , the Most Gracious, the Most Merciful. I begin by offering my deepest gratitude to Allah (SWT).

As the Quran beautifully states:
"And He gave you of all that you asked for. And if you should count the favors of Allah, you could not enumerate them." (Quran 14:34)

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ABSTRACT

Illicit financial outflows have emerged as a significant concern in South Africa, impeding economic growth, exacerbating social inequality, and undermining the country's developmental efforts. This research report aims to investigate the crucial role of corporate governance in reducing illicit financial outflows in South Africa. By examining the factors contributing to these outflows and exploring the effectiveness of corporate governance mechanisms, this study provides insights into how ethical and accountable business practices can contribute to curbing illicit financial activities.

This research report highlights significant corporate scandals in South Africa, underscoring the imperative need for strong corporate governance practices to prevent illicit financial outflows. Despite sterling efforts, various areas require improvement and pose distinct challenges. Enforcing corporate governance practices demands adequate resources and capacity within regulatory bodies. Additionally, challenges include the lack of transparency in beneficial ownership and limited shareholder activism, both hindrances to curbing illicit financial outflows.

Collaborative efforts are paramount, with stakeholders, including regulatory bodies, companies, shareholders, and the government, working together to fortify corporate governance frameworks, enhance regulatory oversight, foster ethical business conduct, and elevate public awareness. Critical areas of focus encompass strengthening internal controls, ensuring board independence and composition, addressing executive compensation structures, promoting shareholder engagement, enhancing risk management and internal control mechanisms, and improving regulatory oversight and enforcement. Moreover, fostering collaboration among stakeholders and upholding ethical standards are essential elements in curtailing illicit financial outflows, ultimately fostering transparency, accountability, and sustainable economic development in South Africa.

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1. INTRODUCTION

1.1 Background

Many developing countries do not reap the full benefits from their wealth in natural resources. One of the major causes is illicit financial outflows that is, money that ends up benefiting local and foreign elites rather than the general population.[1] Much of this money is generated by corruption, illegal resource exploitation, and tax evasion.[2]

Illicit financial flows (IFF) is the unlawful transfer of money or capital from one nation to another.[3] A substantive outflow of money from developing states hampers their ability to meet obligations by reducing funds for essential services, increasing debt, impeding development projects, and eroding economic sovereignty.[4] This precise delineation encompasses various activities, such as concealing the profits of criminal endeavors, directing funds to illicit destinations, and circumventing tariffs and taxes through the misrepresentation of financial transactions.[5] Broader interpretations of illicit financial flows often center on actions that, while not strictly illegal, are considered undesirable due to their adverse impact on tax revenues, including tactics like strategic transfer pricing for tax avoidance.[6] A detailed discussion of illicit financial flows will be discussed in section 2 of this report.

Corporate governance is the linchpin that helps prevent and detect illicit financial outflows within corporations. A robust governance framework not only promotes transparency, ethical behavior, and compliance with financial regulations but also reduces the likelihood of financial improprieties and the associated illicit flows of capital.[7] Corporate governance encompasses the structures, processes, and mechanisms through which companies are directed, controlled, and held accountable.[8] Section 3 will outline the rules and guidelines that govern the behavior of companies, their executives, directors, and other stakeholders with focus on how these rules and guidelines can prevent the damaging effect of illicit transfer of capital.

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[1] Thando Ngozo 'Illicit Financial flows in the Mining Industry in South Africa' available at: https://www.oxfam.org.za/wp-content/uploads/2020/11/oxfam_illicit-financial-flows-report_fin_web.pdf accessed 4 May 2023.
[2] Ibid.
[3] Global Financial Integrity 'Illicit Financial Flows' available at: https://gfintegrity.org/issue/illicit-financial-flows/ accessed on 18 September 2023
[4] Ibid.
[5] Tshepo H. Mongalo, '*Possible Contribution of Corporate Law Remedies to Curbing Illicit Outflow of Capital From Africa*' (2015) 1 *JCCL&P* 4.
[6] Global Financial Integrity 'Illicit Financial Flows' available at: https://gfintegrity.org/issue/illicit-financial-flows/ accessed on 18 September 2023.
[7] Rehana Cassim & Femida Cassim 'The reform of corporate law in South Africa' *I.C.C.L.R*. 2005, 16(10), 411-418
[8] Jean Jacques du Plessis, Anil Hargovan, and Jason Harris 2018 *Principles of Contemporary Corporate Governance* 4th ed Cambridge: Cambridge University Press 6-17

South Africa has implemented various measures to curb illicit financial outflows in addition to corporate governance structures.[9] The South African Revenue Service (SARS) has bolstered tax and exchange control measures, primarily aimed at combating transfer pricing abuses and regulating tax havens. Simultaneously, there has been an intensification of regulatory oversight concerning financial institutions, marked by the granting of increased powers to regulatory bodies for monitoring and investigating financial misconduct.[10] South Africa is actively engaged in various international initiatives and organizations, such as the FATF (Financial Action Task Force) and the OECD (Organization for Economic Cooperation and Development) Global Forum, focused on combating illicit financial activities that transcend borders.[11]

Additionally, enhanced measures related to reporting and transparency have been put into effect, including stringent requirements for maintaining accurate financial records and adhering to corporate governance codes. Furthermore, whistleblower protection laws have been enacted, providing individuals with the confidence to report illicit financial activities without the fear of reprisal.[12] The abovementioned points are briefly acknowledged in this report but are not explored in-depth, as the report specifically concentrates on corporate governance within the given context. Despite these efforts, challenges in enforcement, coordination, and capacity building persist, requiring continuous improvements and collaboration among government agencies and stakeholders. An identification of strengths and weaknesses is illustrated in section 4.7 of this report .

Strong corporate governance practices can help prevent and detect illicit financial outflows by fostering a culture of integrity and ethical behavior within organizations as will be outlined further in section 4. When companies adhere to principles of transparency, accountability, and sound risk management, they are less likely to engage in activities that facilitate the movement of illicit funds. By implementing effective internal control mechanisms, such as robust financial reporting systems and

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[9] These include enacting the Financial Intelligence Centre Act 38 of 2001 (FICA) to enhance customer identification, transaction monitoring, and reporting of suspicious activities. See also Tshepo H. Mongalo, '*Possible Contribution of Corporate Law Remedies to Curbing Illicit Outflow of Capital From Africa*' (2015) 1 *JCCL&P*, 4 where his paper emphasized the necessity for enhanced transparency measures in financial markets, particularly in scrutinizing the conduct of related companies involved in international trade. He further states that recent reports reveal that 50% of international trade occurs within groups of companies, potentially indicating collusion to conceal assets and underreport profits through the creation of fictitious expenses within the group. The paper suggests that forging partnerships can significantly diminish this detrimental phenomenon by eliminating tax havens, improving transparency in financial markets, and prosecuting individuals involved in corrupt activities that contribute to illicit capital outflow.

[10] Lee Ann Steenkamp "Combating impermissible tax avoidance through efficient administrative approaches: what SARS can learn from its Canadian counterpart" *The Comparative and International Law Journal of Southern Africa* 2012 45(2) 230.

[11] Conference of Ministers of Finance, Planning and Economic Development "Illicit Financial Flow Report of the High Level Panel on Illicit Financial Flows from Africa" available at : https://www.unodc.org/documents/NGO/AU_ECA_Illicit_Financial_Flows_report_EN.pdf accessed on 20 July 2023

12 The Protected Disclosures Act 26 of 2000

independent audit functions, companies can identify and prevent financial irregularities that could contribute to illicit outflows.

This introductory section has outlined the illicit financial outflows in developing countries, with a specific focus on South Africa. The subsequent sections will delve deeper into the role of corporate governance, the measures taken to combat illicit financial flows in South Africa, and the challenges that persist in enforcing these measures. Furthermore, This research report will examine how strong corporate governance practices can contribute to the prevention and detection of illicit financial outflows, shedding light on the importance of ethical conduct, transparency, and risk management within organizations. An examination of cases in South Africa will be addressed throughout the report illustrating the link between good corporate governance and illicit outflows.

1.2 Research Objectives and Research Questions

The object of this research report is to consider how good corporate governance can address the conundrum of illicit financial outflows in South Africa, ultimately providing valuable insights for policymakers, regulators, and businesses seeking to combat this issue and promote ethical conduct within organizations. This research report will consider the following research question:.How the nature of the relationship between poor corporate governance practices and illicit financial outflows in South Africa contributes to the outflow of funds?

In answering this question, the following ancillary questions will be considered:

1.2.1. What are the key corporate governance factors that have the potential to reduce illicit financial outflows in South Africa, and how these factors operate within the specific context of the country?

1.2.2. To what extent are the existing corporate governance mechanisms are effective in addressing illicit financial outflows in South Africa, and what are the strengths and weaknesses of these mechanisms?

1.2.3. Based on the findings, what recommendations can be made for enhancing corporate governance frameworks in South Africa to effectively mitigate illicit financial outflows, and how can these recommendations inform policy-making, regulation, and business practices in the country?

2. UNPACKING ILLICIT FINANCIAL OUTFLOWS IN SOUTH AFRICA

2.1. *What are illicit financial outflows?*

The urgency of addressing illicit financial outflows, as underscored by a working paper by Global Financial Integrity (GFI), cannot be overstated.[13] This research report considers that curbing illicit financial outflows from Africa stands as a pivotal means to unlock a substantial source of funding for poverty reduction and economic expansion in the foreseeable future. "Illicit money is money that is illegally earned, transferred, or utilized. If it breaks laws in its origin, movement, or use, it merits the label."[14] Illicit Financial Flows is concisely characterized within the African context as "capital generated within the continent, which belongs to the continent and then leaves the country through unlawful means."[15] This description encapsulates the profound consequences of illicit financial outflows for the African continent, highlighting the critical importance of understanding and addressing this issue. This section of this report sets the stage for a comprehensive exploration of the multifaceted concept of illicit financial outflows, their far-reaching impact on South Africa's development and the role of good corporate governance in reducing illicit financial outflows.

2.2. *Factors contributing to illicit financial outflows in South Africa*

South Africa faces several factors that contribute to the prevalence of illicit financial outflows.[16] This subsection delves into the specific factors that drive illicit financial flows in the country and explores issues such as weak regulatory oversight, inadequate enforcement mechanisms, corruption, tax evasion, capital flight, trade misinvoicing, and abuse of offshore financial centers.[17] To combat illicit financial outflows, companies and managers must fully grasp these factors in the realm of corporate governance, allowing for targeted prevention and utilization of mechanisms through the development of effective strategies.

2.2.1. *Capital Flight*

Capital flight occurs when individuals and businesses move funds out of the country to avoid taxes, political instability, or economic uncertainty. Illicit outbound investments

[13] Global Financial Integrity 'Illicit Financial Flows' available at: https://gfintegrity.org/issue/illicit-financial-flows/ accessed on 18 September 2023.
[14] Tshepo Mongalo Possible Contribution of Corporate law Remedies to curbing Illicit outflow of capital from Africa. 2015 1(1) *Journal of Corporate and Commercial Law and Practice* 7.
[15] African Union Commission 'Illicit Financial Flow- Report of the High level panel on illicit financial flows from Africa' available at: https://www.unodc.org/documents/NGO/AU_ECA_Illicit_Financial_Flows_report_EN.pdf accessed on 1 May 2023 .
[16] Landry Signé, Mariama Sow, Payce Madden 'Illicit financial flows in Africa' available at https://www.brookings.edu/wp-content/uploads/2020/02/Illicit-financial-flows-in-Africa.pdf accesssed on 1 May 2023.
[17]African Union Commission 'Illicit Financial Flow- Report of the High level panel on illicit financial flows from Africa'.

involve the transfer of funds through fraudulent means, including overinvoicing or false declarations.[18] Capital flight poses significant concerns for various reasons. In South Africa, it exacerbates the country's existing financing gaps and urgent development needs.[19] This outflow of capital, by depleting domestic savings and the tax base, hampers the availability of resources for essential investments and public expenditures necessary to address developmental requirements.[20] It also highlights policy and regulatory shortcomings as it reflects the failure to encourage domestic investment and effectively curb illicit capital outflows.[21]

Capital flight is indicative of broader institutional decay, enabling the unlawful accumulation of wealth, illicit cross-border transfers of foreign currency, and the concealment of private assets in offshore jurisdictions beyond the reach of national authorities.[22] It is closely intertwined with the concept of state capture, which involves collusion between political elites and domestic or foreign private interests driven by the pursuit of personal wealth.[23]

2.2.2. *Transfer Pricing and Base Erosion*

Transfer pricing is an accounting practice that represents the price that one division in a company charges another division for goods and services provided.[24] Transfer pricing thus refers to the manipulation of prices in transactions between related entities to shift profits to low-tax jurisdictions.[25] This practice reduces taxable income in higher-tax jurisdictions like South Africa, leading to illicit financial outflows.[26]

2.2.3. *Trade Misinvoicing*

It is widely acknowledged that trade misinvoicing is a major conduit for illicit financial flows. By overpricing imports and underpricing exports on customs documents, residents (natural or juristic persons alike) can illegally transfer money abroad.[27] Trade misinvoicing serves as the predominant quantifiable method employed in South Africa

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[18] Daily Maverick 'On the Trail of Capital flight from Africa' Available at https://www.dailymaverick.co.za/article/2022-04-05-on-the-trail-of-capital-flight-from-africa-sets-out-the-urgent-need-to-effectively-combat-this-scourge/ accessed on 01 May 2023 .
[19] Léonce Ndikumana, Karmen Naido, Adam Aboobaker *Capital flight from South Africa: A Case Study* (published paper series University of Massachusetts-Amherst).
[20] Ndikumana et al Op cit note 19.
[21] Ndikumana et al Op cit note 19.
[22] Ndikumana et al Op cit note 19.
[23] Ndikumana et al Op cit note 19.
[24] Mohammed Kamdar "Transfer Pricing: the Call for Documents by SARS" *Tax Professional*, 10/2017(30)
[25] Thando Ngozo 'Illicit Financial flows in the Mining Industry in South Africa https://www.oxfam.org.za/wp-content/uploads/2020/11/oxfam_illicit-financial-flows-report_fin_web.pdf accessed 4 May 2023.
[26] OECD iLibrary 'IFFs in the global and South African Context' available at: https://www.oecd-ilibrary.org/sites/b5e31a5f-en/index.html?itemId=/content/component/b5e31a5f-en accessed on 04 May 2023 . Section 31 of the Income Tax Act is South Africa's response and refers to the transfer pricing mechanism. This section applies the arm's length principle to curb transfer pricing.
[27] Mongalo op cit note 5.

to transfer funds out of the country.[28] It involves the deliberate manipulation or misrepresentation of the value of international trade transactions. This manipulation can take the form of misreporting or mispricing. Mispricing occurs when the value of exports and imports in international trade is inaccurately stated. Consequently, trade misinvoicing can lead to either inflows or outflows of funds. In the case of inflows, exports are over-invoiced, while imports are under-invoiced.[29] Conversely, in the case of outflows, exports are under-invoiced, while imports are over-invoiced.[30] This technique can be used to overstate expenses or understate revenues, resulting in illicit financial outflows. South Africa recorded an average annual trade gap of $19.9-billion, around R310-billion, between 2008 and 2017 due to trade misinvoicing, found a new report from Global Financial Integrity, the US-based think tank devoted to analysing illicit financial flows (IFFs). [31]

2.2.4. *Corruption and Bribery*

Corruption and bribery play a significant role in facilitating illicit financial outflows.[32] Funds are siphoned off through illicit payments, kickbacks, and embezzlement. corruption undermines the integrity of public institutions and weakens regulatory oversight.[33] In South Africa, instances of corruption have been reported in various sectors, including government, business, and law enforcement.[34] Corrupt officials have exploited their positions of power to facilitate illicit financial activities, such as providing preferential treatment, overlooking regulatory compliance, or turning a blind eye to suspicious transactions. This allows individuals and businesses involved in illicit activities to operate with impunity and channel funds out of the country undetected.[35] Bribery exacerbates the problem by distorting fair business practices and compromising ethical standards. In the context of illicit financial outflows, bribery is used to secure favorable contracts, permits, or licenses, enabling the flow of illicit

[28] Thando Ngozo 'Illicit Financial flows in the Mining Industry in South Africa https://www.oxfam.org.za/wp-content/uploads/2020/11/oxfam_illicit-financial-flows-report_fin_web.pdf accessed 4 May 2023.
[29] Ibid.
[30] Ibid.
[31] Daily Maverick 'Trade misinvoicing is costing SA Billions in tax revenue' available at; https://www.dailymaverick.co.za/article/2020-03-04-trade-misinvoicing-is-costing-sa-billions-in-tax-revenue/ accessed on 04 May 2023.
[32] African Union Commission 'Illicit Financial Flow- Report of the High level panel on illicit financial flows from Africa' available at: https://www.unodc.org/documents/NGO/AU_ECA_Illicit_Financial_Flows_report_EN.pdf accessed on 1 May 2023 .
[33] Ibid.
[34] Peter Hain 'wake up SA and Act against Corruption' https://www.businesslive.co.za/bd/opinion/2023-03-13-peter-hain-wake-up-sa-and-act-against-corruption/ accessed on 4 may 2023.
[35] Ibid.

funds across borders.[36] Two of many cases such as the State Capture Inquiry[37] and the Arms Deal Scandal[38] have exposed instances of corruption involving public officials, state-owned enterprises, and private entities, resulting in illicit financial flows.These cases will be discussed later in the report.

2.2.5. *Money Laundering*

Money laundering refers to any act that disguises the criminal nature or the location of the proceeds of a crime.[39] In section 1 of FICA 'money laundering' and 'money laundering activity' are defined as an activity which has or is likely to have the effect of concealing or disguising the nature, source, location, disposition or movement of the proceeds of unlawful activities or any interest which anyone has in such proceeds and includes any activity which constitutes an offence in terms of section 64 of FICA or section 4, 5 or 6 of Prevention of Organised Crime Act (POCA).[40] POCA does not define the term "money laundering" but only describes the crime in section 4 of the Act. This practice allows the proceeds of illicit activities to enter the formal financial system and be transferred out of the country.

2.2.6. *Weak Regulatory Oversight*

Inadequate regulatory oversight and enforcement can contribute to illicit financial outflows as highlighted in the case discussed in 2.2.5. Gaps in regulatory frameworks, lenient penalties, and limited resources for investigation and prosecution create opportunities for illicit activities.[41]

2.3. *The Nexus Between Corporate Governance And Illicit Financial Outflows*

Weak corporate governance practices, such as lack of board independence, inadequate risk management systems, and insufficient oversight, can create an environment conducive to illicit activities the like of which is set out above.[42] Conversely, this report investigates how robust corporate governance mechanisms,

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[36] OECD 'Illicit Financial Flows from Developing Countries: measuring OECD Responses' available at: https://www.oecd.org/corruption/illicit_financial_flows_from_developing_countries.pdf accessed on 4 May 2023.

[37] Commission of Inquiry into state capture available at: https://www.statecapture.org.za accessed on 04 May 2023 .

[38] Machanick Phillip 'The arms deal was the ANC's original sin that set the stage for corruption in South Africa today' available at https://mg.co.za/thoughtleader/opinion/2022-12-11-the-arms-deal-was-the-ancs-original-sin-that-set-the-stage-for-corruption-in-south-africa-today/ accessed on 4 May 2023 .

[39] De Koker, L, '*Money laundering trends in South Africa*' (2002), *Journal of Money Laundering Control* 6(1), 27.

[40] Section 1 of the Finanial Intelligence Centre Act 38 of 2001

[41] Ishola Rufus Akintoye, Olateju Somorin, Ayodeji Ajibade, Olubunmi Ogunode' nexus between Tax Havens and Illicit Financial Flows from Africa' (2022) (13) *Research Journal of Financ e and Accounting*.

[42] Naidoo, P "Part : The Board that looked the other way" March 2022 Website at: https://www.linkedin.com/pulse/part-1the-fall-steinhoff-board-looked-other-way-preloshni-naidoo (Accessed on 6 May 2023).

such as strong internal controls, ethical codes of conduct, and effective board oversight, can act as deterrents to illicit financial outflows.[43]

The link between corporate governance and illicit financial outflows is significant. Strong corporate governance practices help establish a framework of transparency, accountability, and ethical behavior within companies, reducing the risk of illicit activities and financial outflows[44]. In South Africa, the Companies Act and King Code IV provide important corporate governance principles that contribute to curbing illicit financial outflows. Below is a discussion on the specific governance mechanisms in company law and their relationship to mitigating such outflows, along with relevant case examples:

2.3.1. Board of Directors and Leadership

Both Section 66 of the Companies Act and King IV Principle 2 highlight the significance of a well-structured and effective board of directors in providing leadership, oversight, and accountability within a company.[45] These provisions emphasize the need for boards to have the necessary expertise, diversity, and independence to make informed decisions and uphold ethical standards in their governance practices.[46] Effective corporate governance requires a competent and independent board of directors that oversees the company's operations, including risk management and financial controls.[47] A diligent and responsible board is crucial in preventing illicit financial outflows. The case of Steinhoff International Holdings[48] serves as an example where the lack of effective board oversight led to accounting irregularities and subsequent financial losses, highlighting the importance of a vigilant board in preventing illicit activities. The Steinhoff Corporate board did not have a governance structure that allowed it to make good decisions.[49] There was clearly an abuse of rights, responsibilities and power in the Steinhoff board.[50] Apart from this, the board structure and composition were also questionable.[51] The company switched from a unitary to a dual (2 tier board) at the time of the board registration on the JSE.[52] The main disadvantages of a dual board structure is that because there is no direct contact

[43] OECD (Organization for Economic Cooperation and Development). (2014). G20/OECD Principles of Corporate Governance. Paris: OECD Publishing.
[44] Surendra Arjoon " Corporate Governance:an Ethical Perspective" *Journal of Business Ethics* 61 2005 343-352.
[45] Mongalo, Tshepo 'Modern Company Law for a Competitive South African Economy' (2010) 259 and S66 of the Companies Act 2008 and King IV Report on Corporate Governance for South Africa 2016. (2016). p.23.
[46] Mongalo op cit note 45 260.
[47] Mongalo op cit note 45 260.
[48] *Tiso Blackstar Group (Pty) Ltd and Others v Steinhoff International Holdings N.V* 2023 (1) SA 283 (WCC).
[49] Naidoo, P "Part : The Board that looked the other way" March 2022 Website at: https://www.linkedin.com/pulse/part-1the-fall-steinhoff-board-looked-other-way-preloshni-naidoo (Accessed on 6 May 2023).
[50] Ibid.
[51] Ibid.
[52] Ibid.

between the executive directors, non-executive directors and board chair.[53] As such there is no transparency.[54] Members have the freedom to engage in unethical activities.[55] One of the main advantages of a unitary board structure is that executives can be asked burning questions while the entire board is present.[56] Since there were 2 separate board meetings in the organisation, there was an asymmetrical flow of information.[57] As a result, direct key oversight could not be performed. The two-tier structure gives the CEO too much leeway to take decisions that in the end led to the near collapse of the company.[58]

Good governance, as a general best practice, is underpinned by Section 66 of the Companies Act and King IV Principle 2 as outlined above. They highlight that a competent and independent board, with the necessary expertise and diversity, plays a vital role in making informed decisions and upholding ethical standards. Effective corporate governance necessitates diligent board oversight of operations, including risk management and financial controls, as this is crucial for preventing illicit financial outflows.

2.3.2. *Risk Management and Internal Controls*

Companies are required to establish robust risk management systems and internal controls to identify and mitigate risks, including those related to illicit financial outflows.[59] In the Tongaat Hulett case[60], the investigation revealed that Tongaat Hulett had inflated its profits and assets over several years, misrepresenting its financial performance.[61] The company engaged in various irregular accounting practices, including recognizing revenue prematurely, overstating the value of land sales, and manipulating financial data to present a more favorable financial position.[62]

As a result of the scandal, Tongaat Hulett's financial statements had to be restated, showing significantly lower profits and a substantial decrease in the company's net asset value.[63] The revelations had a significant impact on the company's reputation and share price, leading to a decline in investor confidence and shareholder value.

The case of Tongaat Hulett [64] best illustrates where inadequate internal controls and mismanagement led to financial irregularities, emphasizing the need for effective risk

53 Ibid.
54 Ibid.
55 Ibid.
56 Ibid.
57 Ibid.
58 Ibid.
59 Companies Act Section 77 and King IV Principle 11.
60 *Tongaat Hulett Limited and Others v Staude and Others* 2023 ZAKZPHC 4.
61 Karl Gernetzky 'Accused Tongaat execs in court over R3.5 billion fraud charges' available at: https://www.news24.com/fin24/companies/accused-tongaat-execs-in-court-over-r35-billion-fraud-charges-20220915 accessed 9 May 2023 .
62 Ibid .
63 Ibid.
64 Ibid.

management systems to prevent illicit activities and financial outflows. In *Tongaat Hulett*, corporate vulnerabilities, arising from inadequate internal controls, mismanagement, and governance failures, can create an environment conducive to illicit financial outflows.[65] Such mismanagement can create opportunities for individuals within an organization to siphon funds illicitly. In addition, this case highlighted the importance of proper financial reporting and transparency in corporate governance.[66] It is submitted that this governance failure created an environment where those engaging in illicit activities faced little scrutiny, making it easier for capital to flow out of the company without detection. It underscored the need for robust internal controls, effective oversight by the board of directors, and accurate financial statements to protect the interests of shareholders and stakeholders. When financial statements are manipulated or obscure, it becomes easier for funds to be moved covertly, masking the true financial health of the company. The case also prompted regulatory bodies and investors to call for stricter adherence to corporate governance principles and enhanced financial reporting standards in South Africa.[67] Such reforms aim to prevent illicit outflows by bolstering oversight, transparency, and accountability within organizations.

2.3.3. *Audit Committee*

The audit committee plays a vital role in ensuring financial reporting integrity, compliance with laws and regulations, and the effectiveness of internal controls. By providing independent oversight of financial reporting, the audit committee helps mitigate the risk of fraudulent activities and illicit financial outflows. [68]

2.3.4. *Ethical Culture and Corporate Citizenship*

The old Chinese proverb “the fish rots from the head” is used to express the idea that all problems in a company or a country can be traced back to its leadership.[69] In any organization, culture determines what is and is not acceptable, and a culture that doesn't encourage transparency and accountability can amplify weakness and hasten failure.[70] Corruption enters an organization (a company or country) through its leaders, filters down to its employees (or citizens), ultimately poisoning everything in that sphere.[71] Some would argue that there are unnerving parallels between current day South Africa and some scandalous corporate failures.[72] With reference to Enron, Dennis Collins suggested that “Enron’s “misdirected evolution” could have been corrected at any time if somebody had stepped forward to fix the broken “moral levees”

[65] Sam Sole ‘Tongaat Hulett bidder in scathing attack on business rescue process’ December 2023 available at: https://amabhungane.org/stories/tongaat-hulett-bidder-in-scathing-attack-on-business-rescue-process/ (accessed on 15 December 2023).
[66] Ibid.
[67] Ibid.
[68]Section 94 of the Companies Act, 2008 and King IV Principle 3.
[69] Naidoo, R ‘An Essential Guide for South African Companies’ 3rd ed (2018) Lexis Nexis: Durban. 6.
[70] Naidoo op cit note 69 at 6.
[71] Naidoo op cit note 69 at 6.
[72] Naidoo op cit note 69.

that allowed the flood of unethical behaviors that eventually resulted in enron's collapse.[73] Enron had a culture of big, brash, competitive spending where each business unit tried to outdo the next. Individual employees were encouraged to get rich obscenely as quick as possible.[74] The company had a culture of no bad news.[75] When Enron was on the verge of failure, senior executives encouraged employees to invest by promising a bounce back in the share price while secretly offloading huge tranches of the company's stock.[76] As long as the company made money (at least on paper), anything goes in the corporate culture in the case of Enron.[77] Promoting an ethical culture and corporate citizenship is crucial in preventing illicit financial outflows. Good Companies are expected to adopt and promote ethical values, integrity, and responsible business conduct.[78]

2.3.5. *Stakeholder Engagement as per King IV: Principle 16*

Effective stakeholder engagement helps create a transparent and accountable environment, reducing the risk of illicit financial outflows.[79] Companies should engage with stakeholders, including shareholders, employees, and communities, to ensure their interests are considered and protected.[80] The case of Lonmin and the Marikana tragedy emphasizes the importance of engaging with all stakeholders to prevent financial mismanagement and mitigate reputational risks that may lead to illicit outflows.It is crucial to note that while the Companies Act and King Code IV provide principles and guidelines for good corporate governance, their implementation and effectiveness rely on companies' commitment and adherence.

2.3.6. *Examining Corporate Governance and Illicit Financial Outflows in South African Companies*

In 2017, investigative journalists in South Africa brought to light the 'state capture' scandal, revealing the Gupta family's alleged undue influence over government officials and state-owned enterprises.[81] Known as the Gupta leaks, these incidents implicated the wealthy business family, closely connected to former President Jacob Zuma, in numerous state capture allegations. The Gupta cases, extensively discussed in relation to illicit financial outflows and corruption, have raised concerns about their impact on the country's governance and economy.[82] This section, delves into the intricate web of corporate governance practices. It aims to provide compelling evidence and insights, emphasizing the crucial role of enhanced corporate

[73] Naidoo op cit note 69 at 398.
[74] Naidoo op cit note 69 at 7.
[75] Naidoo op cit note 69 at 7.
[76] Naidoo op cit note 69 at 7.
[77] Naidoo op cit note 69 at 7.
[78] Section 7 of the Companies Act and King IV Principle 1.
[79] Irene-Marié Esser & Piet Delport 'The protection of stakeholders: The South African social and ethics committee and the United Kingdom's enlightened shareholder value approach: Part 1.' (2017) 50(1) *De Jure Law Journal*, 97-110 .
[80] King IV Report on Corporate Governance for South Africa 2016. (2016) 23.
[81] Gupta-Leaks.com available at:https://www.gupta-leaks.com accessed on 31 May 2023.
[82] Gupta-Leaks.com available at:https://www.gupta-leaks.com accessed on 31 May 2023.

governance in mitigating illicit financial outflows.[83] Through an analysis of the Gupta cases and their implications, the report seeks to affirm that robust corporate governance measures serve not only as essential safeguards against unethical practices but also as crucial tools for preserving a nation's financial integrity and fostering sustainable economic growth.

A. Influence Over State Appointments And Contracts

The Gupta family was accused of exerting undue influence over key government appointments and procurement processes.[84] They used their political connections to secure favorable positions for their associates and gain control over state-owned entities.[85] This allowed them to influence decision-making and direct lucrative contracts towards their businesses. The illicit financial outflows in these cases were facilitated through overpriced contracts, kickbacks, and the use of offshore accounts and shell companies.[86]

B. Oakbay Investments And Other Gupta-Owned Companies

The Gupta family owned several businesses, including Oakbay Investments, which were implicated in allegations of corruption and illicit financial practices. These companies were accused of receiving preferential treatment in securing contracts and conducting business with state-owned entities. Investigations uncovered suspicious financial transactions, including large cash withdrawals, transfers to offshore accounts, and suspicious payments made to politically connected individuals.[87]

In light of Banking Sector Irregularities, the Gupta cases also revealed irregularities in the banking sector related to the movement of funds and suspicious transactions.[88] South African banks faced scrutiny for their role in facilitating these illicit financial flows.[89] Several major banks closed Gupta-related accounts due to concerns about money laundering and adherence to anti-money laundering regulations.[90]

The Gupta cases highlight the complexity of illicit financial outflows and their impact on the South African economy. The allegations involve a range of illicit practices, including bribery, corruption, money laundering, and tax evasion. The investigations into these cases have revealed the need for stronger regulatory frameworks, improved

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[83] The essence of delving into state capture cases in this report lies in highlighting the significance of their discussion by the Zondo commission, leading subsequently to the formulation of the Companies Amendment Bill

[84] Gupta-Leaks.com available at:https://www.gupta-leaks.com accessed on 31 May 2023.

[85] Ibid.

[86] Ibid.

[87] BBC 'State capture: Zuma, the Guptas, and the sale of South Africa' available at: https://www.bbc.com/news/world-africa-48980964 accessed on 18 may 2023.

[88] Gupta-Leaks.com available at:https://www.gupta-leaks.com accessed on 31 May 2023.

[89] Corruption Watch 'Bank Of Baroda Played Key Role In Sa's Gupta Scandal' available at: https://www.corruptionwatch.org.za/bank-baroda-played-key-role-sas-gupta-scandal/ accessed on 29 May 2023.

[90] news24 'Suspect bank flows: These SA transactions highlighted in shock Fin CEN report' available at :https://www.news24.com/news24/bi-archive/fincen-files-south-africa-2020-9 accessed on 29 May 2023.

financial oversight, and robust enforcement mechanisms to prevent and detect illicit financial activities.

C. Estina Dairy Farm

The Estina Dairy Farm scandal in South Africa brought to light a significant case of illicit financial outflows and corruption.

The Estina Dairy Farm project was initiated in the Free State province with the aim of supporting local farmers and developing the dairy industry.[91] However, investigations revealed that the funds allocated for the project were siphoned off through a complex network of corruption and illicit financial activities.[92]

D. Eskom and Transnet

Eskom, the state-owned power utility, and Transnet, the state-owned transport and logistics company, were both embroiled in state capture scandals. It was alleged that corrupt networks, involving politically connected individuals and businesses, were involved in large-scale corruption and illicit financial outflows. The Gupta family's businesses were accused of securing lucrative contracts with inflated prices and facilitating kickbacks, resulting in substantial financial losses for these state-owned entities.[93]

E. Bosasa

Bosasa, a company specializing in catering and facilities management services, was implicated in state capture-related corruption scandals. It was alleged that Bosasa paid bribes to government officials and politicians to secure lucrative contracts with state entities, including correctional services and other government departments. The corrupt activities involved illicit financial flows through shell companies, offshore accounts, and cash payments.[94]

These are just a few examples of state capture cases in South Africa where illicit financial outflows were alleged. In such cases, the illicit financial outflows often involved complex networks of corruption, bribery, money laundering, and fraudulent financial transactions. These activities were aimed at diverting public funds for personal gain, undermining the integrity of state institutions, and impeding economic development.

Addressing illicit financial outflows in state capture cases requires a multi-faceted approach, including strengthening anti-corruption measures, enhancing financial oversight and regulation, conducting thorough investigations, and holding those

[91] EWN 'Estina Dairy Farm' available at: https://ewn.co.za/Topic/Estina-dairy-farm accessed on 29 May 2023.
[92] Ibid.
[93] Gupta-Leaks.com available at:https://www.gupta-leaks.com accessed on 31 May 2023.
[94] Judicial Commission of inquiry into state capture report: Part III Available at : https://www.statecapture.org.za/site/files/announcements/679/OCR_version_-_State_Capture_Commission_Report_Part_III_Vol_IV_-_Bosasa.pdf accessed on 14 May 2023 .

involved accountable.[95] It is crucial to establish independent judicial inquiries, strengthen law enforcement agencies, and foster international cooperation to trace illicit flows, recover stolen assets, and prevent future occurrences of state capture and associated financial misconduct.[96]

Better corporate governance could have played a significant role in preventing or mitigating the detrimental impact of the cases above. Key elements include transparency, accountability, due diligence, risk management, oversight, and adherence to ethical standards. Implementing these practices can help safeguard public funds, protect the interests of stakeholders, and prevent corruption and illicit financial outflows in similar situations. Referring to the cases discussed, paragraph 2.4. will outline mechanisms of illicit financial outflows below in addition to the mechanisms discussed in section above.

2.4. Mechanisms Of Illicit Financial Outflows in relation to the cases discussed

i. Misappropriation of Funds

In the Estina Dairy Farm scandal as outlined in paragraph 2.3.6.A, funds meant for the project were systematically misappropriated. Instead of being used for their intended purpose, the funds were redirected to benefit individuals with close ties to the Gupta family, who were politically connected.[97]

ii. Offshore Accounts and Shell Companies

Illicit financial outflows were facilitated through the use of offshore accounts and shell companies. [98] The funds were transferred to these accounts, which made it difficult to trace and monitor the flow of money. This allowed for the concealment of the illicit activities and the movement of funds beyond the reach of regulatory authorities.[99]

iii. Money Laundering

Money laundering played a significant role in facilitating the illicit financial outflows. Funds were moved through a series of complex financial transactions, making it difficult to trace the origin and destination of the money.[100] The use of layered transactions, shell companies, and offshore accounts helped conceal the illicit nature of the funds and their true beneficiaries.[101]

2.5. Impact on the South African Economy

[95] Dávid-Barrett E. State capture and development: a conceptual framework. *J Int Relat Dev (Ljubl)*. 2023 Mar 23:1-21
[96] Dávid-Barrett E op cit note 93 at 1-21.
[97] EWN 'Estina Dairy Farm' available at: https://ewn.co.za/Topic/Estina-dairy-farm accessed on 29 May 2023.
[98] Ibid.
[99] Ibid.
[100] Ibid.
[101] Ibid.

The Gupta leaks had severe implications for the South African economy as seen in the discussion earlier in this report. The misappropriation of funds meant for development projects undermines economic growth and hampers the country's socio-economic progress.[102] Illicit financial outflows deprive the public of much-needed resources that could have been invested in infrastructure, education, healthcare, and job creation.

Furthermore, the scandal eroded public trust in government institutions and exposed the vulnerabilities in the regulatory framework. It highlighted the need for stronger governance mechanisms, transparency, and accountability in public procurement processes to prevent future occurrences.

2.6. Government Response and Legal Action

Following public outrage, the South African government established a commission of inquiry to investigate the Estina Dairy Farm scandal amongst the others discussed. The commission's findings led to criminal charges being laid against several individuals involved in the misappropriation of funds.[103] This response demonstrates the commitment of the government to address corruption and illicit financial outflows.

The Gupta leaks serves as a sobering reminder of the devastating impact of illicit financial outflows on the South African economy. It highlights the urgent need for robust regulatory frameworks, enhanced transparency, and strengthened oversight mechanisms to prevent corruption and ensure the proper allocation of public funds. It is submitted that efforts must be made to hold those responsible accountable and recover the misappropriated funds. Only through these measures can South Africa curb illicit financial outflows, restore public trust, and promote sustainable development for the benefit of all its citizens.

[102] Ibid.
[103] Ibid.

3. LEGAL FRAMEWORKS AND REGULATORY LANDSCAPE

Overview of South African Company Law in Relation to Illicit Financial Outflows

South African company law provides a comprehensive legal framework for regulating the operations and governance of companies operating in the country. In the context of illicit financial outflows, this overview will examine the relevant legislation and corporate governance guidelines outlined in the King Code IV.

3.1. The Companies Act: Provisions Relevant to Illicit Financial Outflows

In the context of illicit financial outflows, the Companies Act contains several provisions aimed at preventing and addressing such activities. This research report will explore the key provisions of the Companies Act that are relevant to tackling illicit financial outflows in South Africa, highlighting specific sections of the Act.

3.2. Reporting and Disclosure Requirements

Section 29(1)(a) of the Companies Act establishes reporting and disclosure obligations for companies. It requires companies to maintain accurate and transparent financial records and prepare annual financial statements.[104] These financial statements must comply with recognized accounting standards and provide a true and fair view of the company's financial position. By ensuring proper reporting and disclosure, this provision enhances transparency and facilitates the detection of any irregularities or illicit activities related to financial outflows.[105]

3.2.1. Duty of Directors

Directors' responsibilities are crucial for upholding effective corporate governance. In the framework of conventional corporate governance, directors' duties serve to limit the powers of directors while also playing a vital role in fostering positive corporate governance practices within companies.[106] Section 76(3) of the Companies Act sets out the fiduciary duties of directors, which include acting in good faith, in the best interests of the company, and with the required care, skill, and diligence.[107] Directors are obligated to prevent and address any potential illegal activities, including illicit financial outflows. Failure to fulfill these duties may result in personal liability for the directors involved. [108] This provision emphasizes the responsibility of directors to act

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[104] Section 29(1)(a) of the Companies Act of 2008.
[105] Section 29(1)(a) of the Companies Act of 2008.
[106] Tshepo Mongalo & Tshepiso Scott *Corporate law and corporate governance: an overview of business undertakings in South Africa* 2nd edition 2023 200.
[107] Mongalo explains that every director owes fiduciary duties to the company. This is a duty of the highest good faith, 'uberrimae fides' in the Latin phrase. It is the same duty owed, for example, by a guardian to a ward, an agent to the principal, partner to co-partner and an attorney to a client. Mongalo & Scott op cit note 106 at 203.
[108] According to Mongalo, Where a director breaches any duties, there is now scope for personal liability under section 77 of the Act. According to section 78 of the Companies Act, a director may not be

in the best interests of the company and prevent any actions that could lead to illicit financial outflows.[109]

3.2.2. Business Rescue Provisions

Business rescue proceedings are defined as proceedings that are designed to enable the rehabilitation of financially distressed companies.[110] Sections 128 to 154 of the Companies Act provide for business rescue proceedings, which aim to rehabilitate financially distressed companies.[111] It is submitted that these provisions promote transparency, accountability, and the preservation of value within a company. By addressing financial distress, they contribute to reducing the likelihood of illicit financial outflows that may occur during times of financial instability.[112] Sections 128 to 154 contribute to reducing the likelihood of illicit financial outflows during times of financial instability by providing a structured and supervised process that aims to protect the interests of all stakeholders, maintain transparency, and prevent preferential payments or irregular financial activities that could result in financial misconduct.[113] The overarching goal is to rehabilitate financially distressed companies while maintaining integrity in the process. [114]

3.2.3. Insider Trading and Market Abuse

Insider trading is defined as the making of a profit or avoiding of a loss by trading on the basis of material, privileged or non-public corporate information in organized securities markets.[115] Section 78 of the Financial Markets Act prohibits insider trading and market abuse.[116] It establishes mechanisms to prevent the misuse of insider information and maintain the integrity of financial markets.[117] This provision ensures that individuals are held accountable for engaging in such activities, thereby curbing the potential for illicit financial outflows.[118] The various market abuse laws introduced in South Africa were aimed mainly at enhancing the insider trading regulation in order, amongst others, to restore public investor confidence in our financial markets.[119]

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relieved of these duties, either in the memorandum of incorporation, rules or resolutions adopted by a company. Mongalo & Scott op cit note 106 at 203.

[109] Section 76(3) of the Companies Act of 2008 and Mongalo 's discusses

[110] Mongalo & Scott op cit note 106.

[111] Sections 128 to 154 of the Companies Act and Mongalo & Scott op cit note 106 at 360.

[112] Mongalo & Scott op cit note 106 at 359 And Sections 128 to 154 of the Companies Act.

[113] As explained by Mongalo, the purpose of business rescue is to save such companies and to potentially avoid the socioeconomic collateral damage that often results from the liquidation of companies. Mongalo & Scott op cit note 106 at 359.

[114] Mongalo & Scott op cit note 106 at 360.

[115] Herbert Kawadza 'A Discussion of some Aspects of the Regimes for the Regulation of Insider Dealing in South Africa and the United States of America.' *Journal of African Law* (2015) 59(2) at 380-394.

[116] Section 77 and 78 (3)(a) of The Financial Markets Act 19 of 2012.

[117] Howard Chitimira 'A historical overview of the regulation of market abuse in South Africa' *Potchefstroom Electronic Law Journal PELJ* (2014) 17(3), 01-38.

[118] Section 71 of the Companies Act.

[119] Chitimira op cit note 122 at 01-38.

Insider trading can contribute to illicit financial outflows by enabling individuals to profit from undisclosed information.

3.3. KING CODE IV

While the King Code itself is not legislated, it indirectly contributes to reducing illicit financial outflows in South Africa by promoting ethical behavior, transparency, and good corporate governance practices.[120] Companies that adopt and adhere to the King Code are more likely to have robust systems in place to prevent financial misconduct and to maintain the trust of their stakeholders, including investors and the public. Below is a discussion of principles that aid in curbing illicit financial outflows.

3.3.1. Principle 1: Ethical Leadership and Corporate Citizenship

Ethical leadership is vital in curbing illicit financial outflows. Principle 1 of the King Code IV highlights the importance of ethical behavior, integrity, and responsible corporate citizenship.[121] By promoting a culture of ethics and integrity, companies can establish a strong foundation for preventing and addressing illicit financial activities. Ethical leaders set the tone from the top, ensuring that employees and stakeholders adhere to high standards of conduct, thereby reducing the risk of financial outflows through illegal means.[122]

3.3.2. Principle 2: Board Composition and Independence

Principle 2 focuses on the composition of the board and the need for independence. Independent directors play a crucial role in overseeing corporate activities, including financial transactions, risk management, and compliance. Their objective oversight can help identify and prevent illicit financial outflows. By ensuring a balanced board with a sufficient number of independent directors, companies can enhance their ability to detect and address any potential misconduct or irregularities.[123]

3.3.3. Principle 3: Audit Committees and Internal Audit

Audit committees play a critical role in corporate governance. They ensure effective oversight of financial reporting, internal control systems, and risk management processes. A robust internal audit function aids in identifying and preventing illicit financial activities. By adhering to the recommendations regarding the composition,

[120] Institute of Directors South Africa 'Understanding KingIV and what it is intended to achieve' available at: https://www.iodsa.co.za/news/389613/Understanding-King-IV-and-what-it-is-intended-to-achieve.htm accessed on 25 December 2023.
[121] du Plessis et al op cit note 8 at 6-17.
[122] King IV Report on Corporate Governance for South Africa 2016. (2016). 23. See also, The Companies Amendment Bill 2023 proposes that the Social Ethics Committee of a company must comprise at least three members. For public and state-owned companies, all the members must be directors who are not involved in the day-to-day management at the time or in the previous three years (non-executive) and for other companies, the members must consist of no less than three directors or prescribed officers, at least one of whom must be a director who is non-executive
[123] King IV Report on Corporate Governance for South Africa 2016 (2016) p.23.

independence, and responsibilities of audit committees, companies can strengthen their control mechanisms and mitigate the risk of financial outflows.[124]

3.3.4. Principle 5: Integrated Reporting and Disclosure

Principle 5 highlights the importance of integrated reporting, which provides stakeholders with a holistic understanding of a company's performance, risks, and governance practices. Integrated reporting promotes transparency and accountability, making it difficult for illicit financial outflows to go unnoticed. By providing comprehensive and accurate information, companies can enhance stakeholder trust and deter illicit financial activities.[125]

3.3.5. Principle 9: Risk Management and Internal Controls

Principle 9 emphasizes the need for effective risk management and internal control systems. Companies should identify and assess risks, including those related to illicit financial outflows, and implement appropriate controls to mitigate these risks. Robust risk management frameworks and internal control mechanisms can help prevent unauthorized financial transactions and ensure compliance with relevant laws and regulations.[126]

As per the comprehensive analysis of the King Code Principles outlined above, an in-depth exploration of these strengths and weaknesses in existing corporate governance practices is warranted. Such an examination provides insights into the possibilities and obstacles that companies encounter in their endeavors to establish governance structures that prioritize ethics, transparency, and effective risk management.

[124] Ibid.
[125] Ibid.
[126] Ibid.

4. ANALYSIS OF CORPORATE GOVERNANCE MECHANISMS AND RECOMMENDATIONS

Corporate governance mechanisms within a company, aspects of which are discussed in section 3 above, comprise the set of rules and processes that either formally or informally enable the board of directors to govern. These enable the monitoring of strategy, performance and risk and encourage good corporate citizenship and organisational accountability.[127] This section particularly focuses on the board of directors and executive compensation, shareholder rights and activism, auditing and financial reporting, regulatory frameworks and compliance, as well as ethics and codes of conduct. Understanding these is crucial in assessing the effectiveness of these mechanisms in mitigating illicit financial outflows.

4.1 Board of Directors and Executive Compensation

4.1.1 Board Independence and Composition

The Companies Act of 2008 requires boards to have a majority of independent directors as per s66. This provision aims to ensure unbiased decision-making and effective oversight of financial activities, reducing the risk of illicit financial outflows. Furthermore, the King Code IV recommends that boards regularly evaluate their composition to maintain independence and expertise.[128] Independent directors can ensure that financial reporting and disclosure practices are accurate, transparent, and in compliance with relevant laws and regulations.[129] They can challenge management's decisions and demand sufficient evidence for transactions, reducing the likelihood of fraudulent activities that facilitate illicit financial outflows.

4.1.2 Executive Compensation and Incentive Structures

Executive pay is a focal point in the ongoing corporate governance discourse, notably in countries using the 'outsider/arm's-length' system, such as South Africa.[130] This debate gains significance when connected to the broader issue of illicit financial outflows. The compensation structures of top executives raise concerns about transparency, accountability, and the potential for financial misconduct. Addressing executive pay within the corporate governance framework is vital to ensure fairness and prevent avenues contributing to illicit financial outflows. The Companies Act (Section 66) mandates disclosure of director and officer remuneration, enhancing accountability and curbing excessive compensation that might incentivize unethical behavior or illicit financial activities. King Code IV underscores responsible executive

[127] du Plessis et al op cit note 8 at 6-17.
[128] See further discussion in section 4.7.2.1.
[129] King IV Report on Corporate Governance for South Africa 2016 (2016) 23.
[130] Mongalo & Scott op cit note 106 at 257.

compensation aligned with long-term company performance, offering a potential avenue to mitigate illicit financial outflows.[131]

There should be a focus on long-term performance. Executive compensation plans should emphasize long-term performance rather than short-term gains. By linking executive pay to sustainable financial performance, organizations can discourage executives from engaging in fraudulent activities to inflate short-term results.The King IV Report highlights the importance of aligning executive remuneration with long-term value creation and the organization's strategic objectives (King IV, Principle 14.3).[132]

The Eskom corruption scandal in South Africa highlighted the importance of appropriate executive compensation structures in mitigating illicit financial outflows.[133] The scandal involved alleged corrupt activities by executives and suppliers, resulting in significant financial losses for the state-owned power utility.[134] The pending investigation after the State Capture Report released in 2016 by then Public Protector Advocate Thuli Madonsela raised eyebrows on matters of good corporate governance at Eskom.[135] It was shown in public records that many incidents took place at Eskom, including a dysfunctional board of directors, maladministration, irregularities, and poor management.[136] Notwithstanding the attention paid to Eskom over the major payment irregularities, including Impulse International in 2015, the stepdaughter of acting CEO, Matsheka Koko, was granted contracts worth more than R1 billion in any case.[137] This certainly amounted to an illicit flow of capital. Failure to investigate the evidence by Eskom brings up issues with respect to whether the organisation secured unique or special treatment from the power utility. [138]

Following the scandal, there were calls for reforms in executive compensation to ensure accountability, transparency, and ethical conduct. The incidents underscored the need for aligning executive incentives with ethical behavior and long-term performance to prevent illicit financial activities.

4.2. Shareholder Rights and Activism

4.2.1. Shareholder Rights and Engagement

[131] The provisions of the Companies Amendment Bill 2023 mirror those of King IV in that they introduce a new requirement for public companies and state-owned companies to prepare and present a remuneration report.
[132] King IV Report on Corporate Governance for South Africa 2016 (2016) 23.
[133] L Mnganga-Gcabashe 'Report Of The Portfolio Committee On Public Enterprises On The Inquiry Into Governance, Procurement And The Financial Sustainability Of Eskom' (2018) 4
[134] For reasons of practicality, this project will not account in detail problems at Eskom. For a more detailed background and evidence, please see the Report of the Portfolio Committee on Public Enterprises on the Inquiry into Governance, Procurement and the Financial Sustainability of Eskom, Dated 28 November 2018
[135] Fatima Seedat *Section 76 of the Companies Act 71 of 2008 as a mechanism of enforcement for the King IV Code on Corporate Governance for South Africa* (unpublished LLM Dissertation, University of Kwazulu-Natal).
[136]Fatima Seedat op cit note 140.
[137]Fatima Seedat op cit note 140.
[138] Fatima Seedat op cit note 140.

Mongalo states that the importance of shareholder activism is emphasised as a mechanism which should be encouraged in ensuring compliance with corporate governance principles. Section 58 of the Companies Act grants shareholders various rights, including the right to vote on significant corporate matters.[139] Shareholder engagement is crucial in preventing illicit financial outflows as active shareholders can hold management accountable and demand transparency in financial transactions. The Companies Act also encourages the establishment of shareholders' committees to facilitate engagement.[140]

4.2.2. Role of Institutional Investors

Institutional investors, such as pension funds and asset managers, play an important role in curbing illicit financial outflows. The Financial Markets Act (Act 19 of 2012) regulates institutional investors, requiring them to act in the best interests of beneficiaries and exercise due diligence in investment decisions[141]. Recently in South Africa, there is a noticeable trend of investors giving significant attention to corporate governance matters and expressing a keen interest in addressing them.[142] Institutional investors, both locally and globally, are not only establishing investment criteria but are also providing feedback on ways to enhance corporate governance within the companies they invest in.[143] The active participation of investors has the potential to elevate adherence to corporate governance standards.

4.3 Auditing and Financial Reporting

4.3. External Audit and Independent Auditors

The Companies Act (Section 90) mandates that companies appoint independent auditors to conduct annual audits. Auditors play a vital role in detecting and preventing illicit financial activities by providing assurance on the accuracy of financial statements.[144] The Independent Regulatory Board for Auditors (IRBA) oversees auditors' compliance with professional standards and ethics.

4.3.2. Financial Reporting Standards and Transparency

The Companies Act requires companies to prepare financial statements in accordance with the International Financial Reporting Standards (IFRS) and present a true and

[139] Section 58 of the Companies Act 2008.
[140] Shareholder activism is presently encouraged in terms of Principle 17 of King IV (2016).Section 58 of the Companies Act 2008.
[141] The Financial Markets Act 19 of 2012.
[142] Mongalo highlights recent instances where institutional shareholders played a vital role in overseeing corporate governance. This includes their involvement in Shoprite Holdings Ltd, ensuring the company's reacquisition of high-voting deferred shares from entities controlled by the chairperson, Mr. Christo Wiese, aligned with the company's best interests.In the UK, the Hampel Committee acknowledged that institutional investors, despite lacking business management experience, can actively engage in company affairs, as noted in para 5.5 of the Report and King II, para 20, at 14.
[143] Mongalo & Scott op cit note 106.
[144] Section 90 of the Companies Act 2008.

fair view of the company's financial position.[145] Compliance with these standards promotes transparency and helps identify any suspicious transactions or discrepancies that could indicate illicit financial outflows.

4.4. Regulatory Frameworks and Compliance

4.4.1. Regulatory Oversight and Enforcement

Various regulatory bodies, including the South African Reserve Bank, the Financial Sector Conduct Authority, and the Companies and Intellectual Property Commission (CIPC), oversee compliance with corporate governance and financial regulations. These bodies have the power to investigate potential financial misconduct and enforce penalties for non-compliance.

4.4.2. Anti-Money Laundering and Anti-Corruption Measures

South Africa has implemented legislation to combat money laundering and corruption, such as the Financial Intelligence Centre Act (FICA)[146] and the Prevention and Combating of Corrupt Activities Act (PRECCA).[147] These laws require businesses to implement robust anti-money laundering and anti-corruption measures, which contribute to curbing illicit financial outflows.

4.5. Ethics and Codes of Conduct

4.5.1. Corporate Ethics and Whistleblower Protection

Companies are encouraged to adopt codes of conduct and ethical practices to promote integrity and ethical behavior. The Companies Act (Section 159) protects whistleblowers who report unlawful activities, including financial misconduct and illicit financial outflows.[148] This protection encourages individuals to come forward with information without fear of retaliation. An important point to note is that while there have been efforts to enhance legal safeguards, including the introduction of the Protected Disclosures Act and the Whistleblower House there is still a need for further improvements to ensure adequate protection and support for whistleblowers taking into consideration the recent deaths of many whistleblowers in South Africa.[149] Strengthening these laws, promoting a culture of transparency, and fostering a supportive environment for those who expose corruption are vital steps towards building a more accountable and just society in South Africa.[150]

[145] Section 29(1)(a) of the Companies Act, 2008.
[146] Financial Intelligence Centre Act, 38 of 2001.
[147] Prevention and Combating of Corrupt Activities 12 of 2004.
[148] Section 159 of the Companies Act 71 of 2008.
[149] Mandy Wiener *The Whistleblowers* 2nd ed (2023).
[150] Ibid.

4.5.2. Implementation of Codes of Conduct and Ethical Practices

The King Code IV emphasizes the importance of implementing and enforcing codes of conduct that align with ethical standards.[151] Companies are expected to establish ethical cultures, provide training on ethical practices, and establish mechanisms to monitor and enforce compliance. Ethical practices reduce the likelihood of illicit financial outflows by promoting responsible financial behavior.

4.6. Piercing the corporate veil

Piercing the corporate veil is often associated with transparency and accountability.[152] Section 20(9) of the Companies Act provides for piercing the veil where the corporate structure of a company has been abused.[153] In the realm of illicit financial outflows, corporations may exploit complex ownership structures to conceal the true beneficiaries of transactions, making it difficult for authorities to trace and prevent such outflows. An accountability regime must accompany provisions relating to transparency to ensure that those making the disclosures are motivated to do so accurately and properly. It is essential because 'power without accountability invites abuse'.[154] By piercing the veil, legal mechanisms can expose the directors involved in these schemes.[155]

The case of *Ex Parte Gore NO and Others*[156] offers insights into the application of piercing the corporate veil to combat illicit financial flows in South Africa. In this case, the court demonstrated a willingness to look beyond the corporate structure to unveil the true nature of financial transactions, emphasizing the importance of preventing abuse of legal entities for fraudulent purposes.[157] By allowing the veil to be pierced, the court underscored the need for accountability and transparency in corporate affairs. [158] This legal precedent serves as a reference point for the role of piercing the veil in reducing illicit financial flows. It reinforces the idea that when there is evidence of financial impropriety or attempts to conceal illicit activities behind a corporate façade, the courts should be empowered to expose the true beneficiaries and hold them accountable. It is submitted that incorporating such principles into corporate governance practices can act as a deterrent against illicit financial activities, promoting a culture of ethical conduct and financial transparency in South African companies.

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[151] King IV Report on Corporate Governance for South Africa 2016 (2016) 23.
[152] Davis, D (ed) *Companies and Other Business Structures in South Africa* (4th ed; 1st impression) 2019
[153] J Katzew 'Crossing the divide between the business of the corporation and the imperatives of human rights – The impact of section 7 of the CompaniesAct 71 of 2008' 2011 *SALJ* 686 703
[154] Mongalo op cit note 45 at 43.
[155] Davis, D op cit note 157 at 41.
[156] Ex Parte Gore NO and Others 2013 2 All SA 437 (WCC) and Rehana Cassim 'Piercing the Veil Under Section 20(9) of the Companies Act 71 of 2008: A New Direction' (2014) 26(2) *South African Mercantile Law Journal* 307.
[157] Ibid.
[158] *Gore* supra note 161 para 34 and Piet Delport '*Henochsberg on the Companies Act 71 of 200*8' at 82- 86.

Piercing the veil is a vital tool in the fight against illicit financial outflows. By dismantling the protective shield of corporate anonymity, authorities can expose those responsible for undermining the economic well-being of nations.[159] To succeed in this endeavor, a concerted effort is needed on a global scale, involving collaboration between governments, regulatory bodies, and the private sector. It is submitted that through enhanced transparency, technological innovations, and a commitment to strengthening corporate governance, South Africa can work towards a future where illicit financial outflows are effectively curtailed, safeguarding the economic interests of the nation.

South Africa has implemented various corporate governance mechanisms to curb illicit financial outflows. It is submitted that continued adherence to these mechanisms, combined with robust enforcement and stakeholder engagement, is crucial in addressing this pervasive issue and maintaining the integrity of South Africa's corporate sector.

4.7. Identification of Strengths and Weaknesses in existing corporate governance practices

4.7.1. Strengths

With reference to the regulatory framework as discussed in section 3, South Africa has established a comprehensive regulatory framework to govern corporate governance practices. The Companies Act, as well as other regulations and codes such as the King Code of Corporate Governance, provide guidelines and standards for companies to follow. These frameworks promote transparency, accountability, and ethical conduct, which can help prevent illicit financial outflows.

The Independent Oversight Bodies that South Africa as discussed in 4.4. These institutions play a crucial role in monitoring and enforcing compliance with corporate governance practices, including the detection and prevention of illicit financial outflows.[160]

Companies in South Africa are required to adhere to reporting and disclosure requirements, including the submission of audited financial statements. These requirements promote transparency and accountability, making it more difficult for companies to engage in illicit financial activities without detection.[161]

4.7.2. Weaknesses

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[159] Tshepo H. Mongalo, 'Possible Contribution of Corporate Law Remedies to Curbing Illicit Outflow of Capital From Africa' (2015) 1 *JCCL&P*, 1 – 34.

[160] The roles and responsibilities of the Companies and Intellectual Property Commission (CIPC), the Financial Sector Conduct Authority (FSCA), and the South African Reserve Bank (SARB) in corporate governance and including the Companies Act of 2008, the Financial Sector Regulation Act of 2017, and the Banking Act of 1990.

[161] The Companies Act 71 of 2008 and the International Financial Reporting Standards (IFRS).

There are enforcement challenges despite the existence of strong regulatory frameworks, enforcement of corporate governance practices can be a challenge. Limited resources and capacity constraints within regulatory bodies may hinder their ability to effectively monitor and investigate potential instances of illicit financial outflows. This creates opportunities for companies to engage in such activities without adequate detection and consequences.

Another weakness is limited Shareholder Activism. While shareholder rights and activism are important mechanisms for promoting good corporate governance, shareholder activism in South Africa is relatively limited. Shareholders may not always exercise their rights effectively to hold companies accountable for illicit financial outflows, which can weaken the overall corporate governance framework.[162]

4.7.2.1 Effectiveness of Board Structures and Processes

The effectiveness of board structures and processes in South Africa in relation to illicit financial outflows has been a subject of scrutiny in light of numerous cases that have surfaced. While it is important to acknowledge that not all board structures and processes can be generalized, there are certain observations that can be made based on these cases.

By championing ethical behavior and adherence to codes of conduct, they can reduce the likelihood of individuals engaging in illicit financial activities.[163] The Companies Act of 2008 in South Africa mandates directors to act in good faith, with care, skill, and diligence, and in the best interest of the company (Companies Act, Section 76(3)).[164] Independent directors are expected to uphold these principles and act as responsible fiduciaries.

Independent directors can ensure the implementation of strong internal controls and risk management systems to prevent illicit financial outflows. They can review and challenge the effectiveness of control mechanisms and risk management practices to identify and mitigate potential vulnerabilities.[165] However, in some cases of illicit financial outflows as discussed in section 2 of this report, it has been observed that boards may lack sufficient independence, with conflicts of interest and close affiliations to management compromising their ability to exercise independent judgment.[166]

It is thus submitted that effective board structures should provide robust oversight and risk management mechanisms to identify and mitigate the risks associated with illicit financial outflows. This includes the establishment of audit committees, internal control systems, and risk management frameworks. In some instances, inadequate oversight

[162] King IV Report on Corporate Governance for South Africa 2016. (2016) 23
[163] Ibid.
[164] The Companies Act of 2008.
[165] King IV, Principle 11.1 & PA Delport *Henochsberg on the Companies Act 71 of 2008* (2021) Lexis Nexis: Durban.
[166] Ibid.

and control mechanisms have allowed illicit financial outflows to occur without detection.

The diversity of skills, experience, and backgrounds on boards can contribute to effective decision-making and better risk assessment.[167] Boards that lack diversity may be more susceptible to groupthink and may not possess the necessary expertise to address complex financial matters. Insufficient diversity and expertise may result in boards being ill-equipped to effectively prevent or detect illicit financial outflows.

Boards should ensure that appropriate disclosure practices are followed, enabling stakeholders to understand the company's financial position and activities.[168] In cases where there are lapses in accountability and disclosure, illicit financial outflows may be facilitated.

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[167] King IV's Principle 11 emphasizes the significance of managing risk within an organization. It calls for the governing body to oversee risk management in a manner that aligns with the organization's strategic objectives, ensuring a supportive approach to both setting and achieving those goals Mongalo at 250 and 279

[168] King II emphasized the significant benefits of disclosure, noting that it serves as a deterrent to malpractice and excessive executive rewards. The principle also asserted that disclosure can bring attention to misconduct and non-performance, facilitating remedial actions by making it easier for victims to address such issues.

5. CONCLUSION

The nature of the relationship between poor corporate governance practices and illicit financial outflows in South Africa is found to be symbiotic. Weak governance structures, including lax oversight, inadequate transparency, and ineffective enforcement mechanisms, create fertile ground for illicit financial outflows to flourish. The lack of accountability and integrity within corporate entities facilitates the outflow of funds through various illicit channels. There are certain key corporate governance factors have been identified as having the potential to mitigate illicit financial outflows in South Africa. These factors include robust board oversight, transparent financial reporting, effective risk management systems, and strong regulatory enforcement. However, the effectiveness of these factors is contingent upon their implementation and adaptation to the specific context of the country, considering its unique socio-economic and political dynamics

However, there are still areas of improvement and challenges to be addressed. while existing corporate governance mechanisms in South Africa have made some strides in addressing illicit financial outflows, significant gaps and weaknesses persist. Limited regulatory capacity, regulatory capture, and inadequate stakeholder engagement hinder the efficacy of governance frameworks in curbing illicit activities. Additionally, the lack of coordination among regulatory agencies and the prevalence of corruption further undermine these mechanisms. The lack of transparency in beneficial ownership and limited shareholder activism also pose obstacles in curbing illicit financial outflows.[169]

In conclusion, addressing the issue of illicit financial outflows in South Africa requires a comprehensive and multi-faceted approach that tackles the root causes of poor corporate governance practices. By implementing the recommendations outlined in this report, policymakers, regulators, and businesses can work together to build a more resilient and transparent financial ecosystem that safeguards the interests of all stakeholders and fosters sustainable economic growth.

[169] Peter Reuter 'Background Paper on Illicit Financial Flows and Governance: The Importance of Disaggregation' *World Development Report* 2017 20. The Companies Bill also addresses this point.

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