

# Internal Audit Department

Internal Audit has assessed the control condition of key controls related to oversight and supervision activities of Outside Business Activities (OBAs) and Private Securities Transactions (PSTs) within ABC Company Annuities Distributors (PAD) for the period January 1, 2023 to December 31, 2023. A control condition audit is designed to provide reasonable assurance as to the design and effectiveness of the system of internal controls implemented by management.

Internal Audit's testing resulted in the identification of 1 medium risk issue, the summary of which is presented below. The details of the issue identified, and management's action plans can be reviewed in the attached PDF.

Issue Rating	Repeat Issue	Issue Summary	Issue Owner	Due Date	Issue ID
Medium	Governance	ce and supervision controls related to ABC Company Annuities Distributors, Inc. (PAD) Outside Business Activities (OBAs) and personal investments in private securities transactions (e.g., passive investments) needs improvement. The root causes are primarily attributable to the overreliance of self-disclosure by RRs and a lack of consideration to use additional outside data to detect discrepancies in ongoing OBA recertifications as well as a lack of firmwide protocols for system changes to consider regulatory impacts.	Christina Hartnett	10/1/2024	IS-001585

**Control Condition:** Partially Satisfactory

**Control Environment:** Unrated

**Rating Rationale:** Based on the results of the work performed, Internal Audit has concluded that certain elements of the system of internal controls implemented by management need improvement to further mitigate key risks of the business. The issue highlights the need to strengthen controls to improve the overall governance and oversight of OBA and PST processes (e.g., classification and treatment of OBA and PST, independent validation) as well as maintain readily accessible books and records. The current system of key controls in place consists of supervisory activities that are fully relying on self-disclosure and annual attestations. Therefore, the identified issue has meaningful impact on the ability of controls to mitigate business risks. Most Registered Representatives (RRs) in PAD engage in third party sales thereby reducing the risk of having a conflict. As a result, Control Condition has been rated Partially Satisfactory.

**Scope:** PAD has written supervisory procedures in place to record, review, and approve OBAs and PSTs to allow RRs to engage in certain activities in accordance with Company standards and broker dealer regulatory requirements. The scope included an assessment of the design and effectiveness of the key controls related to the supervision and monitoring of OBAs and PSTs. The audit focused on certain key risks including:

- Sales Practices – Ineffective Supervision
- Records Retention – Records Retention
- Governance and Risk Management - Governance

Testing focused on controls in certain key processes including:

- Oversight and governance over the OBA and PST process including:

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- Appropriate classification of OBA and PST
  - Review and approval
  - Supervision and monitoring (e.g., employee attestations)
- Capturing and maintaining accurate books and records

The following processes were excluded from the scope of the review:

- Filing new/amended Form U4's to FINRA as this is the responsibility of the Licensing and Registration Services area (LARS), a centralized function within USB Services, which is subject to separate risk-based audit coverage. The last audit conducted on LARS was in 2019 that resulted in no issues. Furthermore, there have been no significant changes within the process to file new and amended Form U4's.
- OBA and Personal Conflicts of Interest process of non-registered employees as this population is not subject to broker dealer regulatory requirements and is part of the Human Resources hiring screening process that is subject to separate risk-based audit coverage.

Any questions regarding this report should be directed to the Group Vice President or Vice President responsible for the audit, Lily White, and Andrea D'Alessandro, respectively.

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**Issue ID:** IS-001585

**Issue Name:** Governance and supervision controls related to ABC Company Annuities Distributors, Inc. (PAD) Outside Business Activities (OBAs) and personal investments in private securities transactions (e.g. passive investments) needs improvement.

**Issue Description:** FINRA Rules 3270 (Outside Business Activities of Registered Persons) and 3280 (Private Securities Transactions of an Associated Person) (together, Rules) require registered persons / associated persons to provide written notice to the firm prior to participating in any OBA and / or PST, so that the firm can determine whether to permit, prohibit, or limit such activities. As stated in the Rules, an OBA is “any business activity outside the scope of the relationship” between the registered person and the firm for which the person may either “be compensated or have a reasonable expectation of compensation.” Similarly, a PST is “any securities transaction outside the regular course or scope of an associated person's employment” that may or may not include “selling compensation.” Per FINRA, certain OBAs (and PSTs that fall within the definition of an OBA) must be timely reflected on the Registered Representative's (RRs) Form U4. Per PAD policy, all OBAs and personal investments in private securities (private securities transactions are prohibited) are submitted via the OBA Manager which serves as the book of record for ABC Company broker dealers. Further, PAD requires each associated person to complete annual attestations that include information regarding the accuracy and completeness of Form U4 and OBA / personal investments in private securities disclosures.

Internal Audit's (IA) assessment of the design and operating effectiveness of OBA and PST controls for PAD, to ensure compliance with the Rules and internal policy, identified the following concerns:

## Books and Records

IA was unable to obtain documentation and/or evidence in a timely manner to support conclusions reached and approvals received for 141 active OBAs first disclosed prior to 2018. This was due to the firm-wide decommissioning of a previous system (Lotus Notes) that contained the documentation and audit trail of approval which were not readily accessible. Although the records were located and produced, the data was stored in an archive database (iManage) not identified as an official recordkeeping system. Furthermore, this inquiry and review helped enhance the response time that PAD may have in providing similar information to FINRA, should it be requested in the future.

## Supervision of Outside Business Activity

- No reconciliation is currently performed to ensure internal records match that of FINRA Form U4 records. IA's completeness testing identified 10 RRs whose OBA records in OBA Manager did not match FINRA Form U4 records. In 9 instances, the RRs conducted OBAs while associated with a prior broker-dealer, but those same OBAs were never disclosed during their association with PAD. In 1 instance, an OBA was not reported to FINRA.
- Controls and/or processes to proactively identify potential undisclosed activity of a RR could be enhanced. During IA's design of controls testing, it was revealed that limited monitoring is performed by either 1st or 2nd lines. It should be noted that CTU performs sample testing of certain RR emails to identify potential undisclosed OBAs on an annual basis.
- Monitoring and supervision to ensure that appropriate classification and treatment of activity is taking place needs improvement. Based on reperformance testing of 25 disclosed OBAs IA identified one instance of an activity that was improperly reported as an OBA when, based on policies and procedures, it should have been reported as Personal Private Security Transaction (passive Investment).

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## Policies and Procedures

IA noted a discrepancy between PAD Written Supervisory Procedures (WSPs) and PAD Compliance Manual because PAD Policy for Outside Business Activities states that: "PAD Associated persons are not permitted to engage in Private Securities Transactions regardless of whether the associate is compensated or has a reasonable expectation of compensation". However, IA validated that if passive, PAD allows personal investments in private securities. Further, PAD Compliance Manual language seems to allow such transactions: "*Per FINRA Rule 3280, no person associated with PAD shall participate in any manner in a private securities transaction except in accordance with the requirements of the Rule*". IA noted that also PAD SOP-3433 PAD Outside Business Activities Compliance Procedure do not mention that PSTs are not allowed and/or the passive investments allowance and requirements. Finally, the Supervisory Interview Checklist (SIC), a checklist that is used by supervisory principals that contain talking points to have with external wholesaler RRs to remind them of their responsibilities, does not include talking points regarding PSTs. It should be noted that Management has already begun updating the policies and procedures.

**Root Cause Explanation:** The root causes are primarily attributable to the overreliance of self-disclosure by RRs and a lack of consideration to use additional outside data to detect discrepancies in on-going OBA recertifications as well as a lack of firm-wide protocols for system changes to consider regulatory impacts.

**Rating Rationale:** An inadequate program to identify and supervise OBAs and PSTs and as well as management's inability to maintain accurate and readily accessible books and records exposes PAD to the risk that its RRs and associated persons could have been engaging in activities that conflict with PAD's interests and / or violate PAD policies. Additionally, these control gaps could lead to non-compliance with FINRA regulatory requirements, potentially exposing PAD to regulatory scrutiny. FINRA has and continues to identify challenges regarding firms' OBA and PST practices within the industry. At the time of this audit, there were 256 and 11 active OBAs and personal investments in private securities transactions, respectively. However, most Registered Representatives (RRs) in PAD engage in third party sales thereby reducing the risk to moderate. As such, the issue has been rated Medium risk.

**Risk Taxonomy Level 1:** 10. Regulatory Compliance

**Issue Rating:** Medium

**Status:** Open

**Repeat Issue:** No

**Issue Target Date:** 10/31/2024

**Operating Division:** USB-Individual Solutions Group

**Business Group:** Annuities

**Reportable Segment:** Ann-Sales & Distribution

**Action Plan ID:** AC-001567

**Action Plan Description:** As part of the broader BD books and records initiative, locate and retain relevant historical records in an easily accessible location and identify the new location as an additional book and records source.

**Action Plan Owner:**

Shane McGrath

**Action Plan Closure Target Date:**

9/1/2024

**Action Plan Status:**

Open

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**Action Plan ID:** AC-001568

**Action Plan Description:** In conjunction with Compliance, implement on a periodic basis a reconciliation control to ensure that internal records on OBA match that of FINRA Form U4 records.

Action Plan Owner:

Christina Hartnett

Action Plan Closure Target Date:

6/1/2024

Action Plan Status:

Open

**Action Plan ID:** AC-001569

**Action Plan Description:** In conjunction with Compliance, explore and potentially implement various monitoring techniques to help independently validate undisclosed OBA.

Action Plan Owner:

Christina Hartnett

Action Plan Closure Target Date:

6/1/2024

Action Plan Status:

Open

**Action Plan ID:** AC-001570

**Action Plan Description:** Update relevant WSPs and Compliance manuals to be clear, consistent, and accurate to reflect current processes.

Action Plan Owner:

Shane McGrath

Action Plan Closure Target Date:

4/30/2024

Action Plan Status:

Open

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