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Enforcement Alert

Make sure you test systems that monitor fund transfers, case shows

FINRA has made it clear that you need to be careful that the transfer of customer assets to third parties has been approved by the customer, and that it's not part of a rip-off scheme. A recent enforcement case demonstrates that it is serious about this issue.

The St. Louis-based firm **Edward Jones** paid FINRA a $200,000 fine after the SRO determined that the firm failed to test an automated system that was supposed to detect unusual transmittals of customer funds to third parties.

That lack of testing missed a technical flaw that caused the system to not function properly — a shortfall that didn't spot a rep who siphoned more than $1 million out of customer accounts.

Edward Jones violated provisions in NASD Rule 3012 that require firms to verify that their supervisory systems for such transmittals are working correctly.

"Specifically, the firm relied on a defective report to review and monitor third party wires from customer accounts, and failed to properly test and verify that the system providing the report was functioning properly, as required by Rule 3012," says the Letter of Acceptance, Waiver and Consent for the case.

The firm didn't respond to a *BD Week* call for comment. But the Letter of AWC says Edward Jones has corrected the system and has settled with customers that FINRA identified during its investigation.

"This is the first significant enforcement action addressing the 3012 supervisory requirement to monitor funds transmittals since it went into effect in 2005," says **Steve Ganis**, an attorney at **Mintz Levin's** Boston office. "Fraud is a top FINRA priority, and this action shows the monitoring implementation honeymoon is over. Members will be held strictly accountable for not just the existence, *but the effectiveness* of their systems and processes to catch fraud."

"Implementation of compliance systems can be a scramble, and sometimes they just do not work the way they are supposed to," Ganis continues. "This matter shows programming errors can become alleged regulatory violations. Firms should consider the type of review and analysis necessary to be sure that their account monitoring systems, both in-house and vendor-supplied, function as designed and that their output gets the supervisory and anti-money laundering follow-up required."

Says **Ross Delston**, founder of **GlobalAML.com**, an AML consulting firm based in Washington: "I think the closest analogy would be to the independent AML audits that firms are required to conduct period-ically...The failure to conduct an independent AML audit is itself a violation."

Last November, FINRA issued Regulatory Notice 09-64, which deals with this very topic (*BD Week*, Nov. 23, 2010). "Firms that use automated systems to help monitor transmittals and withdrawals must have adequate means to test and review the effectiveness of such systems just as they must monitor manual systems," the notice warns.

In periodically looking over your system and procedures, keep in mind that they can become

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outdated or ineffective for differing reasons, such as business growth, consolidation, new technologies, and changes in the size and frequency of those transmittals, the SRO advises.

The case

In the Edward Jones case, from Jan. 31, 2005 through August 2007, the firm failed to maintain an adequate supervisory system over transfers, FINRA says.

At the time, the firm had electronic systems in place to monitor activity in customers' accounts and to generate different kinds of exception reports. Those systems were implemented in 2003. One such report, called the Same Outside Address (SAO) Report, was designed to detect when at least two customer accounts at the same branch office sent funds via wire transfer or check to the same third-party account during a 12-month period, FINRA says.

When transfers were flagged in this way, employees in the firm's home office then looked into the matter.

In 2007, an SOA report should have flagged three wire transfers from two customer accounts to the same third-party account. The total amount topped $1 million.

But the SOA report was operating improperly during that time because of a software error. The program produced SOA reports, but those reports were incomplete and inaccurate, FINRA says.

Edward Jones didn't perform tests on the system during the years 2005 through 2007. The system's flaw was discovered in 2007 when the firm was investigating wire transfers and checks sent to that third-party account, FINRA says.

FINRA guidance on this area addresses the following ideas:

✔ Procedures should specify *how* instructions to withdraw or transmit assets may be sent, including which employees of an introducing firm are authorized to transmit instructions to the clearing firm on the customer's behalf. Both introducing firms and clearing firms are responsible for having their workers follow those procedures.

✔ Have random sampling and testing of even routine transfers and withdraws.

✔ Closely monitor the use of standing customer instructions for transmitting funds. Keep customer authorizations for those instructions current.

✔ Check to see that the person responsible for reviewing transmittals has a way to review all of them regardless of their form.

✔ Consider whether the thresholds for heightened supervision of transfers are adequate. Ask whether parties can circumvent the parameters by using multiple, smaller transfers that are designed to "fly under the radar."

✔ Check into whether there are certain types of transmittals that won't show up on exception reports.

"I guess you could put this type of testing in the area of deferred maintenance," Delston says. "It's

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deferred maintenance in the sense that it's an area that firms may not want to spend a lot of time and resources on, particularly in times when profit margins are low. So, in that sense the FINRA action is noteworthy. Don't forget about the basics. Make sure that you're doing the testing that's required."■