State of Wisconsin
Department of Employee Trust Funds
Robert J. Conlin
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax 608-267-4549
etf.wi.gov

Correspondence Memorandum

Date: November 17, 2016

To: Audit Committee Members

From: Yikchau Sze, Director
Office of Internal Audit

Subject: Office of Foreign Assets Control (OFAC) Compliance Audit

This report is for Audit Committee review and discussion. No action is required.

Attached is the OFAC Compliance audit report. The results of this audit have been submitted and discussed with the Office of the Secretary, Department of Employee Trust Funds (ETF).

This audit was requested by Division of Trust Finance (DTF) to provide reasonable assurance that the internal controls established by DTF were effective in monitoring OFAC compliance.

Although we identified two findings and two observations that could improve the monitoring process, we concluded that the ETF was in compliance with OFAC and the controls in place were functioning as designed for the month audited.

This audit was conducted by Amelia Slaney, Auditor–Advanced, who will be available at the Audit Committee meeting to answer any questions.

Attachment: OFAC Compliance audit report

Reviewed and approved by Robert J. Conlin, Secretary

Electronically Signed 11/28/16

Board	Mtg Date	Item #
AUD	12.15.16	5

Office of Internal Audit

OFAC Compliance

November 16, 2016

Prepared for Audit Committee meeting of the Employee Trust Funds Board, 12.15.2016

Objective:

The audit objectives were to assess Department of Employee Trust Funds (ETF) compliance with the United States Department of Treasury's Office of Foreign Assets Control regulations and to evaluate the effectiveness of the process in place to monitor this compliance.

Scope:

The audit scope focused on the OFAC compliance verification completed by the Division of Trust Finance (DTF) in August 2016.

Background:

The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against certain foreign persons, entities, and countries. As part of its enforcement efforts, OFAC publishes a list of individuals and entities controlled by, or acting for or on behalf of, certain countries. The list also includes individuals and entities such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and entities are called Specially Designated Nationals and Blocked Persons (SDN). OFAC also provides a search tool on its website for use in evaluating compliance with the SDN list.

OFAC regulations prohibit U.S. financial institutions from engaging in transactions with any persons, entities, or countries that are included on the SDN list. "Employee benefit plans" are expressly included in the definition of "U.S. financial institution" (31 C.F.R. § 560.327). Therefore, the regulations OFAC imposes on financial institutions such as banks, trusts, securities brokers applies equally to public-sector employee pension plans, such as Wisconsin Retirement System, administered by ETF. OFAC can impose both civil and criminal penalties associated with noncompliance, ranging up to $20 million.

To be compliant with OFAC, ETF should be able to identify -- and avoid benefit payments to -- annuitants on the SDN list or annuitants residing in countries subject to sanction. Of the approximately 205,000 annuitants currently receiving monthly benefit payments from ETF, about 330 reside outside of the United States.

OFAC compliance became a particular interest to DTF in April 2016, after ETF was notified by a bank that an annuity payment was rejected and flagged as a potential hit on OFAC's SDN list. The payment was flagged by the bank because the member's address said North Korea, which is one of the countries that OFAC prohibits U.S. financial institutions from dealing with. After further investigation, ETF found that the member's address, which was actually in South Korea, was simply entered incorrectly in the benefit payments system (BPS) and no noncompliance actually occurred. ETF also found that three monthly payments had been made to the annuitant before the bank flagged the individual as a potential hit on OFAC's SDN list.

Although no noncompliance actually occurred, this situation raised concern that if an annuitant did actually move to a country prohibited by OFAC or if a new annuitant has a foreign address in a prohibited country, it would not be caught in a timely manner and could result in noncompliance, and potential fines. Due to the risk associated with compliance in this area and the potential for substantial fines, DTF designed and implemented new procedures to detect noncompliance with OFAC regulations and requested Office of Internal Audit to perform an audit to provide reasonable assurance that the new process in place is effective in monitoring compliance.

Several DTF staff verify compliance with OFAC as part of processing benefit payments. On a monthly basis, a list of all annuitant checks is generated. The names and countries of the foreign annuitants receiving checks are searched for compliance, using the search tool on the OFAC website. In addition, a separate review is completed monthly to ensure all foreign annuitants, including both checks and direct deposits, are in compliance with OFAC. This review is completed using a different OFAC search tool available on the Financial Industry Regulatory Authority's website, FINRA.org (see *Appendix A* for more information on FINRA). Further, a report is generated weekly from the Lump Sum Payment System (LSPS) showing international payments. If there are any, the name and country for each foreign payment will be searched on the OFAC website to verify compliance. A secondary review of LSPS payments is completed on a periodic basis by another DTF staff using the OFAC website.

Conclusion:

The Office of Internal Audit verified ETF's compliance with the Office of Foreign Assets Control for a sample of payments made in October 2016. Our audit also confirmed that the controls established by Division of Trust Finance related to OFAC compliance verification were functioning as designed for the month audited.

We identified two findings during the audit and offered two observations of process improvement for management to consider.

Findings, Observations, Recommendations, and Management Responses:

Findings

1. **DTF's written procedures for OFAC compliance verification are incomplete and do not include the monthly review completed for all foreign annuitants. In addition, DTF has not documented its risk assessment of OFAC noncompliance to support the procedures in place.**

   DTF has not fully documented all steps taken to verify compliance with OFAC. Although the verification of international checks has been completed regularly as part of payroll processing, DTF did not start verifying OFAC compliance for all foreign annuitant addresses, including direct deposit payments, until about June 2016. When OIA reviewed the procedures in September, we noted that the review of all foreign annuitant addresses is not included in the written procedures.

   OFAC's guidance provides that a risk-based approach should be used when considering the likelihood of OFAC noncompliance at an entity. OFAC also provides a matrix of areas to consider as part of the risk assessment. DTF did not document its risk assessment to support the chosen approach for monitoring compliance with OFAC.

   Recommendations:

   We recommend that DTF document all procedures used to verify OFAC compliance. We also recommend that DTF include its risk assessment of OFAC compliance in the procedural documentation.

   Management Responses:

   Management will ensure the OFAC compliance verification process, including all steps taken, are fully documented and integrated into existing documentation for both the weekly benefit payroll processing and the monthly payroll processing procedures. In addition, per OFAC's guidance, management and staff will conduct a risk assessment to determine the likelihood of OFAC noncompliance.

   Responsible staff: Blain Parsons and Julie Bagenski

   Completion Date: January 31, 2017

2. There is no system control to flag a member's account or warn a user if a member's address is in a country prohibited by OFAC.

The Benefit Payment System (BPS) currently allows a user to select a country prohibited by OFAC for a member's address without providing the user with a warning or flag on the account. A system automated preventative control is a more efficient way to monitor OFAC compliance than solely relying on a manual process. Further, it would be more efficient for ETF to stop future payments from being processed at the point of the address change than it would be at the point of processing payroll and the manual OFAC verification.

OIA is aware that the Benefit Administration System (BAS) Rollout 3 will replace BPS. Although a system control would be a more efficient way of ensuring compliance for foreign annuitant payments, it may not be cost efficient to create a system control in BPS at this time. Therefore, if the creation of a system control in BPS is not cost efficient at this time, it should be considered in preparation for BAS Rollout 3.

Recommendations:

We recommend the Division of Trust Finance:

- evaluate whether it is cost efficient at this time to incorporate a system control into BPS that would warn a user if a country prohibited by OFAC is selected as a member's address;
- work with the BAS implementation team to determine if a warning feature can be incorporated into BAS related to OFAC; and
- work with the BAS implementation team to determine whether the entire OFAC compliance verification can be automated through the payroll processing in BAS in the future.

Management Responses:

Currently management has implemented a freeze on changes to ETF legacy systems, including BPS. Although exceptions can be made, we believe making a system change in BPS as described above would not be cost efficient and not a good use of resources given other priorities. A preliminary risk assessment indicates risk of noncompliance with OFAC is low and the current checks and controls to mitigate risk of noncompliance will remain in place.

Management agrees a system control would be ideal and has requested the implementation of a warning feature be considered as part of the BAS project. In addition, we have requested that the payroll process be enhanced to include an automated solution for the overall OFAC compliance process as part of the BAS project.

Responsible staff: Blain Parsons

Completion Date: Late 2019, which is the preliminary timeline for the implementation of BAS Rollout 3

Observations

1. DTF's documentation of the OFAC compliance verification for all foreign annuitants could be improved. In addition, this verification is not included in DTF's monthly payroll processing checklists.

As the OFAC compliance verification is completed for all foreign annuitants, including both checks and direct deposits, the members' names are highlighted after they are verified against the FINRA.org website for compliance. During our audit, we found that no other documentation of the review is included in the file.

In February 2016 ETF hired Clifton Larsen Allen to review and offer recommendations for improvements related to DTF's financial reporting process. One of the recommendations Clifton Larsen Allen offered is that certain attributes should be included as process documentation, such as title, subject, and date, purpose, data input and review validation, data source, and an indicator of completion status. Without sufficient documentation of the review, there is risk that the process may not be completed consistently, or appropriately if the responsible staff were to leave.

In addition, the OFAC compliance verification for *all* foreign annuitants is not listed in any of DTF's payroll processing checklists. Although the OFAC compliance verification for checks is listed on the checklists, the review of direct deposits that is part of the OFAC compliance verification for all foreign annuitants is not included. DTF uses the checklists to ensure that all necessary steps are taken as part of processing payroll. Incorporating this step into the checklist would help ensure that the review is completed before the payments are made, and therefore, would prevent noncompliance with OFAC from occurring.

Recommendations:

We recommend the Division of Trust Finance improve its documentation of the OFAC compliance verification for all foreign annuitants. The file should include the report title, report date, initials of staff completing verification, date of completion, and an explanation for any highlighting used. We also suggest that the Division of Trust Finance's review of all foreign annuitants be included on the monthly payroll processing checklists as a separate item.

Management Responses:

Currently, the first review of the OFAC compliance process is evidenced as a sign-off in the Monthly Processing Plan. Management plans to add the second review to the Monthly Processing Plan as well. Similar to the first review, when the process is complete, the person that performed the process will sign off in the Monthly Processing Plan. In addition, recommended improvements (title, subject, date, purpose, data input & review validation, data source, and an indicator of completion status) will be considered and incorporated either as part of the process documentation or within the evidence of the review that is retained.

Responsible staff: Blain Parsons

Completion Date: November 30, 2016

2. Procedures are not in place to ensure that all address changes are made to all relevant systems at ETF.

During the audit, it was brought to our attention that changes of address are not always updated throughout all relevant systems. Although the process for address changes expands beyond the scope of this audit, we noted process improvements that should be considered to create efficiencies for ETF and to better serve our members.

The responsibility of address changes has shifted between areas at ETF over the past few years. In July 2015 ETF reorganized duties completed by the former Retirement Services Section and attempted to centralize the function of address changes so the Supply and Mail Services Section (SAMS) would have primary responsibility. However, other business areas in ETF, such as the call center (within the Contact Management Section) or the Benefit Initiation Section, receive address change requests from members during the normal course of business. Because most business areas often only update the system that they primarily work with, all related systems are not updated unless the address change is communicated to SAMS separately. SAMS has already established a process to determine which systems to update in terms of address changes. Communicating address changes to SAMS will help to ensure accuracy of addresses between the systems at ETF, will help to clean-up data in preparation for BAS, and is consistent with ETF's previous efforts to centralize the address change function.

Recommendation:

We recommend that the Division of Retirement Services develop a process to notify SAMS of address changes so the changes can be made in all applicable systems as appropriate.

Management Response:

The Division of Retirement Services Leadership agrees with the recommendation to have a more centralized and coordinated approach to process member address changes.

Despite the lack of connection between current legacy IT systems, however, DRS Leadership feels this is a low risk to business operations and to ETF overall. The greatest risk would be to retirees, since that is the one group for whom ETF collects addresses consistently, but BPS is the known source of record for retirees. DRS Leadership is willing to accept that the same member's address is not updated in WEBS because WEBS is no longer used to provide services to retirees.

It should also be noted that retiree address changes taken by call center staff during retiree payroll cutoff are routed electronically to SAMS for processing via the Z-983 service request in CallSS.

The Department is working on a project to implement an integrated Benefit Administration System (BAS). Rollout 2 of the system is scheduled to be deployed on January 1, 2018 and Rollout 3 of the system is scheduled for 2019. An integrated system like the BAS will reduce the lack of coordination and centralization of address changes. DRS Leadership feels the recent operational changes we made with SAMS to centralize most of the address changes and the work to update the relevant systems is an improvement. In addition, the Data Integrity team is working on establishing business rules and processes for address changes prior to the R3 rollout.

For the reasons stated above DRS Leadership agrees with the recommendation but is willing to accept the remaining risk of not having consistent addresses in all legacy IT systems until the BAS is implemented.

Responsible staff: not applicable

Completion Date: not applicable

Audit Methodology and Testing

The following provides detailed information about the audit procedures and testing results.

The OIA conducted this audit by:

- obtaining an understanding of DTF's procedures for OFAC compliance, including interviews with responsible staff, and process walkthroughs;
- obtaining an overview of how address changes are made throughout ETF;
- verifying the completeness of the Foreign Annuitant Address (FAA) report used by DTF;
- reperforming controls;
- testing a sample of members for compliance with OFAC; and
- verifying a sample of addresses with supporting documentation.

Testing of Foreign Annuitant Address Report

In order to verify the completeness of the FAA report used by DTF, we obtained a query of all annuitants currently receiving benefit payments. We compared the annuitants listed with a foreign indicator to the annuitants included on the most recent FAA report. Within the query of all annuitants, we also reviewed the countries listed to ensure that the foreign indicator column was appropriate according to the country listed. During testing, we found that the FAA report was missing a filter, causing the report to sometimes include old addresses for annuitants. Because the missing filter resulted in one additional annuitant being inappropriately included on the FAA report, there was no significant impact on DTF's compliance monitoring. The filters on the FAA report have since been fixed as the result of this audit. After considering the change made to the filters used, the FAA report used to verify OFAC compliance is complete.

Reperformance of Controls and Testing of OFAC Compliance

We tested a random sample of 65 foreign annuitants included on the FAA report in September 2016. For each annuitant selected for testing, we searched the name and country on both the OFAC and FINRA websites. We also selected a recent lump sum payroll week with international payments. We ran the "LSPS IAT Payments" report for the week of August 22, 2016 and found one member to whom an international payment was made. We also searched that member name on both the OFAC and FINRA websites. Based on our testing, the controls used to verify OFAC compliance were placed in operation and operating effectively for the timeframes reviewed. In addition, we found that the members selected for testing were in compliance with OFAC.

Testing of Addresses

We randomly sampled 65 annuitants from a query of all annuitants receiving benefit payments. For each of the sampled annuitants, we traced the addresses from the query to supporting documentation imaged in the Benefits Administration System or noted in the Call and Service System. Based on our testing, address changes for annuitants appeared appropriate.

Appendix

Appendix A- FINRA overview from www.FINRA.org

What We Do

Every investor in America relies on one thing: fair financial markets. That is why FINRA works every day to ensure that:

- Every investor receives the **basic protections** they deserve
- Anyone who sells a securities product has been **tested, qualified and licensed**
- Every securities product advertisement used is **truthful**, and not misleading
- Any securities product sold to an investor is **suitable** for that investor's needs
- Investors receive **complete disclosure** about the investment product before purchase

To accomplish our dual mission of investor protection and market integrity, FINRA performs the following activities every day:

1. Deter misconduct by enforcing the rules

FINRA's mission is to safeguard the investing public against fraud and bad practices. We pursue that mission by writing and enforcing rules and regulations for every single brokerage firm and broker in the United States, and by examining broker-dealers for compliance with our own rules, federal securities laws and rules of the Municipal Securities Rulemaking Board.

All brokers must be licensed and registered by FINRA, pass our qualification exams and satisfy continuing education requirements.

Every day, hundreds of professionally trained FINRA financial examiners are in the field taking a close look at the way brokers operate, with a focus on the greatest risks to the markets and investors. We conduct routine examinations, as well as inquiries based on investor complaints and suspicious activity. And we review all broker advertisements, websites, sales brochures and other communications to make sure brokers present information in a fair and balanced manner.

Every year, FINRA reviews about 100,000 individual advertisements and communications from firms to investors.

2. Discipline those who break the rules

We have the experts, technology and authority to respond quickly to wrongdoing. If brokers break the rules, we can fine, suspend or bar them from the industry.

Through our aggressive vigilance, in 2015, we brought 1,512 disciplinary actions against registered individuals and firms, levied fines totaling $95 million and ordered restitution of $96.6 million to harmed investors.

- FINRA barred a broker after finding that he took unfair advantage of an elderly customer by having the customer give him successor trustee and residual beneficiary roles and responsibilities even though he knew the customer had twice been diagnosed with Alzheimer's disease and suffered from dementia and memory loss. Following the customer's death, the broker attempted to inherit more than $1.8 million from the customer's estate. FINRA also found that the broker concealed his roles as a fiduciary to the customer and a beneficiary of her trust from his employers.
- In another case, FINRA barred a broker and ordered him to pay more than $138,000 in restitution and $300,000 in disgorgement, along with prejudgment interest. The sanctions followed a finding that the broker directed customers to transfer their funds to a company he owned and controlled for the purpose of investing in securities. Instead of investing the funds in securities as the customers directed, the broker used $474,000 to buy a house. In addition to misusing the funds, he concealed his misconduct from his customers by making supposed interest payments of nearly $36,000 and by causing false documentation of their purported securities investment to be sent to the customers.
- After finding that a broker intentionally engaged in a pattern of deceiving unsophisticated, elderly customers in order to take their money, FINRA took swift action to bar the broker from the industry. FINRA found that the broker convinced his elderly customers to liquidate their assets and led the customers to believe that their liquidated assets would be invested in securities. Instead of investing the customer's funds, he deposited $227,150 of customer money to his personal bank account for his own personal benefit and fabricated account statements to conceal his misconduct.

3. Detect and prevent wrongdoing in the U.S. markets

FINRA uses technology powerful enough to look across markets and detect potential abuses. Using a variety of data gathering techniques, we work to detect insider trading and any strategies firms or individuals use to gain an unfair advantage.

In fact, FINRA processes, on average, 50 billion—and up to 75 billion—transactions every day to build a complete, holistic picture of market trading in the United States.

We also work behind the scenes to detect and fight fraud. In addition to our own enforcement actions, in 2015, we referred more than 800 fraud and insider trading cases to the SEC and other agencies. When we share information with other regulators, it leads to important actions that prevent further harm to investors.

4. Educate and inform investors

We believe an essential component to investor protection is investor education. We provide investors with tools and resources that can help them make wise financial decisions.

Through the FINRA Investor Education Foundation, we equip underserved audiences nationwide with resources needed for financial success and teach investors to protect themselves from financial fraud.

Our website, FINRA.org, offers dozens of free resources about investing and avoiding fraud, including online calculators and investor alerts.

- FINRA's BrokerCheck allows investors to research the professional backgrounds of current and former FINRA-registered brokerage firms and brokers, as well as investment adviser firms and representatives.

- Our Market Data Center provides investors with a wealth of information on a variety of financial instruments, including data on bond market activity from FINRA's Trade Reporting and Compliance Engine (TRACE).
- FINRA provides an easy-to-use, online Fund Analyzer that allows investors to compare expenses among funds—or among different share classes of the same fund.
- Our Risk Meter allows investors to determine if they share characteristics and behavior traits that have been shown to make some investors vulnerable to investment fraud.
- And by asking just four questions, our Scam Meter can help investors assess whether an investment opportunity is too good to be true.

5. Resolve securities disputes

When problems between brokers and investors occur, we administer the largest forum specifically designed to resolve securities-related disputes between and among investors, securities firms and individual brokers.

Our dispute resolution forum is the largest in the country for the securities industry, handling nearly 100 percent of securities-related arbitrations and mediations from more than 70 hearing locations—including at least one in all 50 states, London and Puerto Rico.