



Legal Risk Management Tip June 2006

Testing of Internal Controls

This is the first of five risk management tips addressing the process of **building internal controls**.

In order to ensure that internal controls are effective, thought must be given on how to design the control and what the control is to protect. One way to measure effectiveness of internal controls is through **testing**. Testing helps us to answer “what am I missing” in the control process.

Our first tip relates to internal controls designed to protect clients from abusive sales practices. Many firms utilize electronic surveillance systems to monitor compliance with procedures for a particular product or service (such as portfolio management). Aside from the routine surveillance of these transactions, it is important to conduct forensic testing to ensure the integrity and design of the internal control.

For example, broker-dealers may wish to “test” surveillance controls by reviewing sales practices of the organization’s top producers. Consider performing a comprehensive review of:

- Sales activities based on volume of business;
- Advisers with the highest number of “red flags” on surveillance reports;
- Advisers on pre-approval; and
- Top producers who have been with the firm less than a year.

On the other hand, investment advisory firms may choose to focus on:

- The management of portfolios and with the highest assets under management;
- Portfolios with client account restrictions;
- Pricing control practices; and
- Investment Adviser Representatives who have been with the firm less than a year.

Conducting in-depth analyses such as these will help to identify “gaps” that may exist in the compliance program and will validate that the firm is capturing the necessary internal control information.

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