Defining and Auditing AML Board Oversight for Subsidiary Entities
(It’s Not Just the Parent Company Anymore!)

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Executive Summary

Regulatory expectations defining anti-money laundering (“AML”) oversight obligations of a company’s board of directors are clear. Or, are they? Corporate governance obligations and expectations are clearly addressed in regulatory guidance; however, specific guidance related to the role of boards of directors of subsidiary companies (“subsidiary boards”) is more limited.

Lack of adequate and consistent subsidiary board engagement with respect to AML activities in multi-entity firms typically due to a centralized nature of AML programs can expose a parent company to gaps in AML compliance programs and further expose parent company boards to scrutiny. An important trend warranting internal audit’s focus on AML oversight by subsidiary boards is the trifold combination of increased focus on AML (the bar is even higher), strong expectations for managing third party relationships, and increased board and individual accountability.

The challenge in addressing this problem is determining what level of AML oversight by a subsidiary board is appropriate and how can internal audit assess a subsidiary board’s effectiveness in performing AML oversight? This white paper considers the current environment, exposes the balancing act required for effective AML board reporting top down (parent company) and bottom up (subsidiary level), and provides discussion of key factors internal auditors should consider when defining and auditing AML oversight obligations of subsidiary boards.

Background

We operate within a current regulatory environment of heightened expectations, including early signs of increasing personal liability (e.g., fines, suspensions, criminal charges) and increased focus on board accountabilities. Targeting of boards of directors and senior management is amplified, specifically related to their role and responsibilities, their failure to prevent AML program weaknesses, and their obligation to take corrective action to remedy program weaknesses.

Generally, boards of directors are accountable for oversight of the management and activities of a company, including compliance programs and activities. Increasingly, recent enforcement actions and communications from regulators indicate the application of “heightened expectations” related to board of directors’ oversight and
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corporate governance. Internal audit is well-positioned to help identify potential gaps in parent company board of directors’ AML oversight activities as well as provide the parent company board of directors assurance that the subsidiary boards are executing on their AML obligations. Using risk assessment processes can help internal audit determine frequency of subsidiary board AML audits through identification of those legal entities within a complex organizational structure that are engaged in potentially higher risk AML activities or jurisdictions.

This white paper illustrates the impact on subsidiary boards and AML Officers* of new heightened expectations and provides a methodology for internal auditors to assess subsidiary level board effectiveness, including board awareness, of AML related activities.

Internal audit must spend time examining parent company and subsidiary board roles and responsibilities, and board oversight of AML activities. A review of subsidiary board meeting minutes can provide insight into topics, discussion, and details considered by the subsidiary board. A passive review of reports provided to subsidiary boards will not be sufficient under new heightened expectations. Instead, a risk-based and active evaluation of subsidiary board training, reporting, and oversight including judgmental assessment of the subsidiary board’s effectiveness through interviews and identification of specific AML accountabilities should be implemented. For example, with respect to training, multi-entity firms may face unique challenges related to AML training for subsidiary boards (since such board members may already be internal employees and therefore be considered to have completed the firm’s standard AML training courses).

There must be acute awareness of AML accountabilities within subsidiary entities. In other words, while the parent company board and AML Officer may be ultimately accountable for the AML activities of the parent company and all its subsidiaries, there must be transparency of roles such that specific individuals are charged with AML accountabilities.

WARNING

“Directors of wholly-owned subsidiaries might adopt a relaxed approach in performing his or her duties on the basis that the parent company is the sole shareholder of the subsidiary.”

Throughout this white paper, the use of “AML Officer” is intentionally a generic reference, intended to permit global application of these concepts wherein the “AML Officer” title may be different, such as Money Laundering Reporting Officer (“MLRO”), Bank Secrecy Act Officer (“BSA Officer”), or AML/Counter Terrorist Financing Compliance Officer, among others.

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accountabilities for each subsidiary entity. Those individuals should be jointly accountable to the AML Officer and the subsidiary boards.

The Problem

The problem is identifying a potential lack of consistent subsidiary board engagement and oversight of AML activities in multi-entity firms typically due to centralized nature of AML programs. These programs may be designed to address the business activities and employee base across the corporate group yet expose the parent company to gaps in AML programs on an entity-by-entity basis. More specifically, an internal auditor performing firm-wide AML audits (e.g., at the holding company level) is faced with the challenge of how to evidence that consistent and effective board oversight across multiple legal entities is occurring at the holding company, affiliate, and subsidiary levels. Moreover, board materials and minutes may evidence content but not reflect engagement or actions by board members.

One approach subsidiary boards may take in managing AML oversight when adopting centralized programs may, in essence, imply an “outsourcing” of the subsidiary board’s responsibilities to the parent company’s board of directors, who is accountable for aggregate oversight of entities consolidated under the parent.

In complex organizations with large numbers of legal entities, AML board reporting and oversight is necessarily and intentionally aggregated and designed to be focused on the parent company in particular when subsidiary boards adopt centralized programs and controls. Additionally, a company’s culture of compliance may lean toward reliance on parent level oversight activities. In these cases, a fluid awareness of individual accountabilities for AML oversight is essential to support subsidiary boards in their oversight obligations.

The World Has Changed – Who’s Accountable?

In January 2014, the OCC proposed formal guidelines for its “heightened expectations.” Thomas Curry, Comptroller of the Currency, indicated these guidelines are “designed to strengthen the risk management and governance practices of our large banks” and highlighted the “need for an engaged board of directors that exercises independent judgment” and the “need for a robust audit function.” In July 2014, the Offices of Inspector General recommended US regulators “further examine methodologies to support enforcement actions that permanently ban
from banking those individuals whose actions harmed financial institutions based on a willful or continuing disregard for the safety or soundness of the institutions.\(^8\)

Additionally, review of enforcement actions and AML news articles indicates that growing attention is targeted at parent company boards, in particular where there are centralized AML programs within multi-entity firms (i.e., affiliates and/or subsidiaries operating independently within a firm-wide compliance risk management program without the benefit of the parent company providing adequate oversight of its subsidiaries).\(^9\) However, it is just a matter of time when the governance practices and focus trickle down to subsidiary boards. A September 2014 enforcement action is notable in its specific reference that a bank holding company “on a firmwide basis implements an effective compliance risk management program for BSA/AML compliance that is commensurate with the Subsidiary Banks’ compliance risk profiles, and any services that [the holding company] performs for the Subsidiary Banks regarding compliance with BSA/AML Requirements meet regulatory expectations.”\(^10\)

The trickle down evolves further within the European Union’s proposal for a Fourth Money Laundering Directive which introduces a definition of ‘senior management.’ Article 3 provides that "senior management means an officer or employee with sufficient knowledge of the institution's money laundering and terrorist financing risk exposure and sufficient seniority to make decisions affecting its risk exposure. It need not, in all cases, involve a member of the Board of Directors.” Dublin-based A&L Goodbody highlights that this definitional change may, in practice, target AML officers (i.e., Money Laundering Reporting Officers in Europe).\(^11\) Internal audit should assess how subsidiary boards maintain sufficient knowledge of AML risk exposures, regardless of centralized parent company programs, and how decisions related to a particular legal entity’s AML risk exposure are made.

New legislation in the US furthers the accountability trend. U.S. Representative Maxine Waters introduced new legislation to amend the Bank Secrecy Act, H.R.3317. Entitled the “Holding Individuals Accountable and Deterring Money Laundering Act,” the legislation just by its name should cause all board members – parent company and subsidiary – to take pause. Accountability is the now the hallmark of AML expectations, and although there is perhaps a small chance of H.R.3317 being enacted (it was referred to Committee in October 2013), the new legislation signals a shift in mindset from collective accountability to individual accountability. It proposes an increase in civil penalties and criminal prosecution for willful violations of AML laws, an increase the civil penalty for negligent violations of AML laws, and a penalty on partners, directors, officers, or employees of a financial institution for violations. In addition, H.R.3317 proposes a twenty year (maximum) prison term for individuals who facilitate evasion of AML or control.
KPMG provides research supporting board-level engagement expectations, and noted in its February 2014 report that “98 percent of respondents confirmed that AML issues are discussed formally at the Board, with the majority stating that this was done on a quarterly or as-required basis.” KPMG also suggests that “Senior management needs to concentrate on establishing strong AML assurance mechanisms and globally consistent procedures, to avoid censure, and possible prosecution.”

Combined with increasing emphasis on development of subsidiary governance frameworks, it is appropriate to not examine these statistics or regulatory pressures as mandated requirements, but as creating an opportunity to further enhance the transparency of accountability and expectations of information sharing between parent boards and subsidiary boards.

In this new era of heightened expectations, we are witnessing the first individual accountabilities. In February 2014, the Financial Industry Regulatory Authority ("FINRA") fined Brown Brothers Harriman & Co. $8 million and also fined an individual, the company’s former Global AML Compliance Officer, $25,000. In April 2014, the former Chief Compliance Officer at MoneyGram International was “asked to take an indefinite leave of absence from his position… to focus his attention on his personal situation related to FinCEN” (i.e., preparing “to defend against a potential $5 million fine” related to his role in AML failures at MoneyGram, the world’s second largest money-transfer firm). These individual accountabilities are the tip of the enforcement iceberg and highlight compliance officer liabilities but, when combined with the focus on accountabilities and corporate governance, imply board members may be next in line.

Recent enforcement actions also highlight board oversight expectations. A sample of publicly available regulatory enforcement actions, consent orders, and speeches regarding comparative word choice over time reveals increased references to “Board must” from “the Bank must,” or “senior management must” which signals increased accountability of a board to cause actions to take place in “the Bank” or via “senior management.” Trends in word choice, in particular related to “accountability” and its variations, can be a leading indicator of how criminal prosecutions may become more prevalent as opposed to only civil penalties being imposed.

A final concept in this new world when accountability is at the forefront is the essential role of compliance culture in an organization, and how that culture cascades from the tone set at the top of an organization throughout all of its subsidiaries. For example, the Federal Financial Institutions Examination Council (“FFIEC”) mandates, through its Bank Secrecy Act/Anti-Money Laundering Examination manual, “The board of directors and management should create
a culture of compliance to ensure staff adherence to the bank’s BSA/AML policies, procedures, and processes.”

The compliance culture is essentially the ‘naught line of defense’ in the oft-applied three lines of defense of risk management, one that the others are founded on and that respects the independent roles of risk management lines of defense while simultaneously bonding them together.

Subsidiaries often reflect a separate culture than that of a parent company or other subsidiaries, based on a subsidiary’s operating environment, location, business focus, and/or personnel mix. Subsidiary boards are in a unique position to cascade the culture desired by a parent company throughout a multi-entity organization, in particular when subsidiary board members are also members of senior management. Although perhaps challenging to assess as it relates to subsidiary boards, “Directors of wholly-owned subsidiaries might adopt a relaxed approach in performing his or her duties on the basis that the parent company is the sole shareholder of the subsidiary.”

Audit techniques to evaluate the ‘naught line of defense’ may be a worthy investment to help internal auditors refine scope and testing samples for AML audits.

Accountabilities and Documentation (to support how to address the problem in midst of heightened expectations)

A comparison of recent explicit mandates from regulators (rules or guidance) and implied or additive mandates (speeches) reveals the evolution to a focus on individual accountability, drawing attention to board members and senior management, who are often the sole members of wholly owned subsidiaries.

According to the FFIEC, there should be evidence in reviews of subsidiaries of “which portions of the BSA/AML compliance program are part of the consolidated BSA/AML compliance program.” This information is critical when scoping and planning an AML internal audit. The efficient practice of subsidiary board adoption of a parent company’s centralized AML program and policies should include confirmation of roles and responsibilities, adding language (if not there already) within subsidiary board resolutions that addresses how the subsidiary board adopts the parent company program and also how (to what extent) the subsidiary board retains and performs oversight duties related to the subsidiary, using information provided by the centralized AML program.
Subsidiary boards should also formally attest confirmation of compliance to the parent company and adequate escalation of potential issues† to the parent. Additionally, a subsidiary’s specific AML Policy, if such a separate document is required due to the nature of the specific legal entity, should specifically state that the subsidiary has adopted and complies with the parent company program. If the parent company’s program is not adopted in full by the subsidiary, then the subsidiary’s policy must clearly state what is included and what is excluded (and why). Internal audit should seek to ensure there is documentation evidencing how a risk assessment at the subsidiary level addresses factors unique to the subsidiary and, in the absence of board language above, make recommendations to enhance the documentation.

In the United States, FinCEN ruled that when a subsidiary loan or finance company is obligated to comply with the AML and SAR regulations that are applicable to its parent financial institution and is subject to examination by the parent financial institution's Federal functional regulator, the loan or finance company, upon successful examination, is deemed to comply with FinCEN’s regulations. This is an explicit tie-back to subsidiary obligations.

An important trend for focusing on AML board oversight for subsidiary entities is the combination of increased focus on AML (the bar is even higher) and the OCC’s expectations for managing third party relationships. The OCC states “A bank’s use of third parties does not diminish the responsibility of its board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws.” In a centralized model for multi-entity organizations, the AML parallel is that expectations for outsourcing activities to third parties and implementing a framework for reasonably monitoring those activities implies subsidiary boards who ‘outsource’ oversight obligations to their parent company’s board of directors should perform third party management due diligence best practices to ensure the subsidiary’s unique AML considerations and risk assessment is adequately developed and monitored. An annual re-adoption of a parent company program will not be sufficient under “heightened expectations.”

Therefore, a subsidiary board may have ‘outsourced’ the AML program, process, and controls to the parent company and/or to an accountable party such as the compliance officer aligned with that entity, but that does

† Documentation should also indicate there was no escalation if there were no identified issues.
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not absolve the subsidiary board of its responsibilities for AML compliance and its obligations to understand what was outsourced, and for monitoring and managing the effectiveness of that program with respect to the subsidiary level entity.

Especially where individual accountabilities, including fines and/or jail time, are on the line, there should be renewed focus on the role of documentation to evidence clear accountabilities and oversight responsibilities including process, identification of control breakdowns, cyclical improvements, and reasonable assurance of compliance to AML requirements. A prudent practice would be to evidence such when subsidiary boards are confirming their adoption of a parent company’s centralized AML programs.

The Top Ten Techniques for Auditing Subsidiary Board AML Oversight

The good news is that internal auditors already have the tools to audit subsidiary boards. Where programs are centralized and random sampling techniques are conducted centrally across multiple legal entities, the challenge may be in introducing a new audit approach to AML corporate governance, in particular where subsidiaries are not accustomed to individual attention on AML topics from internal auditors or regulators. Internal audit must apply a risk-based approach to its audit planning in order to determine the extent of its audit, driven by the AML risk assessment. While subsidiary level audits may vary depending on the business activities of the subsidiaries, no legal entity should be missing from audit’s workpapers.

1. **Consider a subsidiary governance framework for AML.** Internal audit must obtain a complete list of the legal entities, their business purpose and activities, and board membership. Internal audit should request ‘subsidiary governance framework for AML’ documentation and consider recommendations to implement such if it is not in place. The framework should address how the various subsidiaries are incorporated into the parent company risk assessment and how that risk assessment is shared back to those individual subsidiaries. Internal audit should assess the adequacy of the parent company’s process to review and update its subsidiary governance framework for AML.

Many subsidiaries may have such a specific focus in their individual activities that their AML assessment is considered immaterial in the scheme of a parent company with many operating subsidiaries. Internal audit should consider that as only an influence on the timing and refresh of audits of subsidiary board activities, not as permission to

“*In addition, there is movement towards recognizing the role subsidiaries have in terms of corporate governance, reporting and managing risk.*”21
disregard the entity in audit scoping. Is the AML risk assessment relevant and complete for each subsidiary? Even if the subsidiary is for a special purpose or other vehicle, ensure an AML assessment is documented and periodically refreshed. For example, internal audit may consider a tiered approach to timing of audits varying from annual to once every few years depending on the legal entity AML risk assessment and any material changes to the subsidiary’s business activities.

2. **Recognize one size does not fit all.** That’s worth repeating. One size does not fit all. There will be no standard form audit for subsidiary board governance, but internal audit should evidence how it approached planning for its audit of subsidiary board AML oversight (yes, write it down!).

3. **Identify who is accountable for each legal entity.** Internal auditors should consider creating an independent grid of who has what specific authority and responsibilities for AML monitoring at the subsidiaries and how results of such monitoring are shared back to the subsidiary board. Who specifically is accountable at each level of the legal entity organizational chart to ensure the subsidiary is adequately addressed within firm-wide risk assessments? Who is responsible at the top?

An interesting exercise is to ask subsidiary board members the same questions. Also, ask questions about the process at the parent company – the parent company may not have the details on subsidiaries (except the big ones) but should have the knowledge of the process in place to manage them (refer back to the subsidiary governance framework). When interviewing the parent company’s AML Officer for large complex banking organizations, ask if he/she is aware of the scope of entities and the business activities in which they operate? Document subsidiary board roles and responsibilities for AML to ensure accountabilities for all legal entities and reconcilement of such to the parent company. For example, a special purpose vehicle entity may have minimal requirements compared to a uniquely regulated entity with its own AML requirements such an operating subsidiary in another country.

Commonly, within large complex organizations, the AML Officer reports regularly to the Audit Committee, a sub-committee of the parent company board. Does this structure exist also at the subsidiary level? Should it? Internal audit is accountable to validate if the AML Officer has the authority to manage an effective AML program and adequate resources to monitor and sustain that program, and this may include a direct reporting line to the board. In a subsidiary governance framework, to what extent should that model be replicated to create or avoid redundancy? Should companies consider explicit AML accountabilities for
one member of each of its subsidiary boards or senior management with that individual annually attesting to the appropriateness of adoption of the parent company’s AML program?

Is there or should there be a person within the centralized AML organization or line of business who is identified as accountable for attesting compliance with AML requirements for each legal entity to the subsidiary board and AML Officer? Does that person have adequate skills, expertise, training, authority, and support with respect to both AML and the entity’s business activities?

- Does that person have direct access to the subsidiary board (and to the parent company’s AML Officer)?
- How often and in what context does that person interact with the subsidiary board?
- How is this documented?

4. **Assess knowledge and oversight through interviews.** Internal auditors should recognize that AML reporting may be provided to senior management of subsidiaries and their boards already but that will not be enough under heightened expectations. Internal audit should assess the knowledge and oversight of subsidiary boards. This can take the place with interview questions such as:

- What is the AML risk exposure faced by the subsidiary?
- Who specifically is accountable to ensure AML obligations of the subsidiary are adequately achieved?
- Does the subsidiary board have a self-assessment process?
- What training does the subsidiary board receive to understand and maintain its knowledge of the subsidiary’s AML obligations, whether or not the subsidiary has adopted the parent company program?
- What metrics does the subsidiary board use to monitor and validate compliance with the parent company program and/or the subsidiary’s unique program elements?

5. **Evaluate board-specific AML training.** Audit techniques to assess subsidiary board training should leverage enterprise-wide training but specifically target board member training.

- Is there training addressing AML responsibilities of board members for both parent company and subsidiaries?
- Ask parent and subsidiary board members “What are you as a member of the board of directors individually accountable for?”
• Ask subsidiary board members “What specifically are you accountable for if the subsidiary relies on (has ‘outsourced’) oversight to the parent company through a subsidiary board resolution adopting the parent company program?

• When subsidiary boards comprise solely employees and not external board members, is there specific training on board responsibilities provided to those employees beyond standard AML training the parent company provides to all employees? Internal audit should consider recommending a possible solution: role-based training targeting those employees who also serve as board members?

6. **Review board reporting, materials, and minutes.** Internal audit should sample AML materials and reporting provided to the board and review board meeting minutes, both top down (parent company) and bottom up (subsidiary/other legal entity level).

• Consider whether there is unique risk assessment content for a subsidiary board or aggregated risk assessment consolidated at the parent company or other group level. What does the subsidiary board receive as reporting or evidence of AML program effectiveness and does it help the subsidiary board execute its oversight responsibilities?

• To what extent is the subsidiary board aware of parent company regulatory findings and commitments, specifically related to centralized AML programs (i.e., internal regulatory findings debriefs where relevant and benchmarks to publicly available enforcement actions and trends)?

• Examine the frequency of AML reporting to the board and to what extent the reporting is or should be unique to the subsidiary.

• Validate the existence of a top-down/bottom-up reporting cycle such that subsidiary level reports are shared with centralized AML functions and the AML Officer can attest to the parent company board of directors that adequate programs are in place across all subsidiaries. A reporting cycle must be appropriate to the organization (again, not one size fits all).

• Who prepares and presents reporting to subsidiary boards and what closed loop process exists to ensure continuous feedback and connection between parent and subsidiary?

• Consider also the forums by which board meetings take place. A virtual subsidiary board meeting, though efficient and cost-effective, may lend itself to potential disengagement in particular for board members who are also internal employees as multi-tasking related to daily business operations demands constant attention (“just a quick check of email”). A Harvard blog notes that “productivity goes down by as much as 40%” and “people distracted by incoming email and phone calls saw a 10-
point fall in their IQs,” findings that may warrant consideration when individual accountabilities (and jail time) may be on the line.

7. **Evaluate how subsidiary boards re-adopt centralized parent company AML programs.** Internal audit should assess to what extent there are oversight activities beyond re-adopting the parent program annually. Is the subsidiary board adoption of a parent company AML program an assembly line update process that becomes an annual administrative exercise or a thoughtful look-back and look-forward review of AML implications for the subsidiary? What do the meeting minutes reflect?

8. **Ask “Is AML on the agenda?”** Ask the simple question (and confirm by looking at subsidiary board meeting agendas and meeting minutes to assess the level of detail): Is AML on the agenda? If it’s not on the agenda, chances are it’s not addressed.

9. **Assess differences between board and senior management.** Is there a distinction between the responsibilities of subsidiary boards and the responsibilities of senior management? If applicable (it may not be in the case of small or special purpose subsidiary structures), how does the subsidiary board challenge the subsidiary board’s senior management? If the subsidiary board does not believe its senior management is supporting the culture of compliance or is executing effectively its AML day-to-day responsibilities, then the subsidiary board must initiate corrective action and ensure escalation to the parent company.

10. **Consider third party risk management techniques.** “No news is good news” and “out of sight, out of mind” are not sufficient corporate governance techniques for subsidiary boards. Drawing again the parallel to third party management and risks associated with outsourcing, what is the process for evidencing whether AML oversight is adequate (e.g., via reports/updates from the accountable party). Internal AML auditors would be well served to discuss best practices with their third party risk management audit counterparts.

**Conclusion**

In this environment of heightened expectations, firms must reconcile AML accountabilities across all entities within the parent company. Firms must identify and document AML oversight
obligations of all boards of directors within a corporate group, not just those at the parent company level. Internal audit must spend time examining subsidiary boards’ roles, activities, and oversight of AML activities.

Trends related to board oversight and individual accountabilities challenge internal audit to assess what level of AML oversight by a subsidiary board is appropriate and how effective is that oversight. A passive review of reports provided to boards is not sufficient. Instead, an active evaluation of board training, reporting, minutes, and oversight including judgmental assessment of board effectiveness through interviews and identification of specific AML accountabilities should be considered.

Internal audit’s independent assessment of subsidiary board effectiveness and reconcilement of individual legal entities to the parent company can help evidence to regulators the strength of an AML program (regulator’s reliance on internal audit workpapers). Board members and others accountable for AML may just welcome internal auditors with open arms on this topic.

**A Note from the Author:**

Thoughtful Reader, if your firm is already doing the above, this white paper provides support for continuing to perform these activities. If your firm is not doing above, this white paper provides support for discussing, initiating, and documenting your decisions related to these “define and audit” activities, using a risk-based approach appropriate to your organization, to benefit subsidiary board members in their oversight obligations and avoid fines, penalties, suspensions, and/or jail time.

I am interested in what you think about this white paper. Please email me at tamara.a.darnow@key.com and let me know your thoughts. All feedback, good, bad, or indifferent, is welcome and appreciated. If you found this article beneficial and would like to see a future article addressing perhaps more in depth audit techniques for board member interview questions, the ‘naught line of defense’ concept, additional research on multi-tasking impacts, or other topics stemming from this white paper, please email me.

Respectfully,

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*KeyBank N.A. is a wholly owned subsidiary of KeyCorp (NYSE: KEY). Any views expressed are personal and not necessarily those of KeyCorp.*
References

1 Examples include, but are not limited to:
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     (https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_039.htm);
   - Basel Committee on Banking Supervision “Sound management of risks related to money
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   - “Compliance Risk Management Programs and Oversight at Large Banking Organizations with
     Complex Compliance Profiles” SR 08-8 / CA 08-11, October 16, 2008.

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8 “Enforcement Actions and Professional Liability Claims Against Institution-Affiliated Parties and
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