



January 12, 2018

By Electronic Mail to [pubcom@finra.org](mailto:pubcom@finra.org).

Jennifer Piorko Mitchell  
Office of the Corporate Secretary  
Financial Industry Regulatory Authority  
1735 K Street, NW  
Washington, DC 20006-1506

**Re: FINRA Regulatory Notice 17-38:  
SIFMA Comment on Proposal to Amend FINRA Rule 3110 (Supervision) to  
Provide Firms the Option to Conduct Remote Inspections of Offices**

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> appreciates the opportunity to respond to the request for comment issued by the Financial Industry Regulatory Authority (“FINRA”) in Regulatory Notice 17-38 (“RN 17-38”)<sup>2</sup> regarding a proposal to amend Rule 3110 (Supervision) to provide firms the option to conduct remote inspections of offices and locations meeting specified criteria.

## **I. EXECUTIVE SUMMARY**

SIFMA strongly supports FINRA’s efforts to amend Rule 3110 to provide firms with the option to conduct remote inspections of offices that meet specified criteria. Without detracting from that support, our comments on RN 17-38 highlight various improvements that we respectfully submit for FINRA’s consideration during the amendment process for Rule 3110. SIFMA members’ comments primarily respond to FINRA’s first, third, fourth, and fifth requests for comment in RN 17-38, as explained in Sections II.B.1, II.B.2, II.B.3, and II.B.4 below.

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<sup>1</sup> SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$18.5 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

<sup>2</sup> [http://www.finra.org/sites/default/files/notice\\_doc\\_file\\_ref/Regulatory-Notice-17-38.pdf](http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-38.pdf).

## II. COMMENTS

### A. General Comments

SIFMA members recognize the centrality of a firm's responsibility to supervise its associated persons and the activity conducted at all of its office locations. Effective monitoring prevents and detects compliance challenges and deficiencies, which can be harmful to investors and costly to a firm. Appropriately tailored supervision requirements can improve firm efficiency and protect investors. Accordingly, SIFMA supports FINRA's efforts to adopt and enforce supervision rules that promote diligent and thorough inspections of office locations. Our comments reflect our member firms' commitment to transparency, compliance, and investor protection and are intended to give FINRA the information it needs to finely hew its proposed revisions to Rule 3110 to achieve FINRA's stated goal of "reducing the burden of on-site inspections in limited circumstances that would not result in a diminution in investor protection."

As noted in RN 17-38, we are concerned that as currently written Rule 3110's requirement of on-site inspections for all offices, irrespective of office type, imposes costs and burdens on firms that cause inefficiencies and do not improve the efficacy of firms' monitoring efforts. The on-site inspection requirements are particularly burdensome relative to their benefit for offices with fewer personnel or operations posing a lower risk of investor harm. By utilizing ever-advancing technology, associated persons perform activities in geographically disperse locations to a far greater extent than in the past. Decentralized, alternative, and mobile work arrangements can improve investor services, firm efficiency, and quality of life for associated persons. Many of these locations engage in low-risk activity. While we agree that firms must appropriately supervise all locations, regardless of size, operations, or geographic location, on-site inspections for these locations is increasingly costly and time-inefficient. These burdens not only impact firms' revenue, but they impose regulatory and compliance opportunity costs, detouring valuable resources that could be better deployed supervising higher-risk locations and activities.

Fortunately, modern technology has made it feasible to conduct remote virtual inspections that meet the same qualitative standard as on-site inspections. To a similar degree as on-site inspections, remote inspections can "assist firms in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with FINRA rules."<sup>3</sup> While SIFMA recognizes that periodic on-site inspections are important to the effectiveness of any supervision program, remote inspections are also appropriate in certain circumstances and can help firms allocate resources to closer monitoring of relatively higher-risk activities. Many offices simply do not conduct activities that warrant devoting significant firm resources toward conducting on-site inspections.

As currently proposed, Rule 3110.15 would provide the option to conduct remote inspections for a small number of these low-risk offices in limited circumstances. While the

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<sup>3</sup> FINRA Rule 3110(c)(1).

revised Rule 3110.15 would provide slightly more flexibility than the status quo, the rule unfortunately would have a relatively small impact as currently written and would not allow firms to fully realize the intended benefits of the changes. In particular, the provisions limiting the definition of “qualifying office” to offices with no more than three associated persons and to offices not held out to the public as an office of the member would significantly limit the application of the proposed rule changes. We believe that the proposed definition of qualifying office can be appropriately expanded in order to further advance FINRA’s purpose in proposing the rule modification.

While SIFMA applauds the purpose underlying the proposed rule modification, we respectfully submit a number of suggestions to ensure that FINRA’s laudable goals can be achieved. Specifically, and as detailed below in Section II.B, we believe that Rule 3110 should permit firms additional flexibility in meeting the definition of “qualifying office.” SIFMA suggests that the rule’s purpose would be further advanced by allowing firms to conduct remote inspections according to a risk-based approach similar to the approach FINRA and the SEC use to develop examination schedules and priorities. We believe such a change would lead to more widespread adoption of remote inspection protocols, thus reducing burden and improving the efficiency of supervision programs.

## **B. Specific Issues**

*1. How does the firm currently fulfill its obligations under Rule 3110(c) for those offices or locations at which few associated persons reside and limited or low-risk activities occur? In what way(s) would the use of remote inspections impact the firm’s current inspection process or practices?*

Currently, firms inspect offices that are staffed with few associated persons and that conduct low-risk business activities on a multi-year cycle, which does not require firms to expend a significant amount of time and expense. Rule 3110(c)(1)(C) provides that firms must inspect non-branch locations on a regular periodic schedule, with a presumption that a non-branch location will be inspected at least every three years. A firm is allowed to establish a longer periodic inspection schedule as long as the firm documents in its written supervisory and inspection procedures the factors used in determining that a longer periodic inspection cycle is appropriate.<sup>4</sup> In establishing such a schedule, the firm must consider the nature and complexity of the business activities for which the location is responsible and extent of contact with customers.

Proposed Rule 3110.15 would have a limited impact on all firms’ current inspection practices because the only offices that would meet the proposed definition of “qualifying office” are non-branch locations, which are already inspected on a more lax schedule as described above. In effect, proposed Rule 3110.15 would only apply to locations such as offices of convenience, primary residences, and vacation homes. Given the small number of offices eligible for remote inspection under the proposed rule it would be uneconomical for some firms

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<sup>4</sup> FINRA Rule 3110.13.

to conduct an internal analysis for the purpose of identifying offices eligible for remote inspection, and thereafter design a virtual inspection process that would meet FINRA scrutiny.

Further, firms are unlikely to conduct an internal analysis or design a virtual inspection process because of the lack of clarity around what constitutes a suitable remote inspection. Accordingly, we request that FINRA provide guidance on what constitutes a suitable remote inspection, and whether that requires interviews of branch personnel, video conferences, or other investigatory aids.

*2. Are there other criteria for a “qualifying office” that should be considered?*

The purpose of Rule 3110.15 would be further advanced by allowing firms to conduct remote inspections according to a risk-based assessment similar to the approach FINRA and the SEC use to develop examination schedules and priorities. In line with the industry regulators’ practice of designing efficient and effective exams around risk, firms should be able to craft suitable inspections for office locations based on an internal risk-rating system that considers factors such as the office’s size, the scope of business activities, the nature and complexity of the products or services offered at that location, the disciplinary history of associated persons designated to that location, and any indicators of irregularities or misconduct.

This risk-based assessment would not affect the frequency of a firm’s inspection schedule; it would simply determine whether a remote inspection is appropriate for a given office. SIFMA members understand that FINRA and the SEC rely on firms to conduct internal inspections on a more frequent basis than their exam schedules in order to monitor business activity and prevent misconduct between exams. SIFMA therefore does not suggest that the number of inspections is limited.

*3. The proposal seeks to limit the number of associated persons designated to a qualifying office to three. Is this threshold reasonable? If not, why not? Is there a more appropriate threshold and why?*

SIFMA recommends limiting the number of persons designated to a qualifying office to five *registered representatives*, as opposed to three *associated persons*. The number of registered representatives designated to an office is a better indicator of the type of business conducted at an office and a more useful threshold for determining the amount of customer interaction occurring at an office. Because associated persons perform such a wide variety of functions for a firm, the number of associated persons at a location tends to be a poor measure of risk attributable to a certain location.

In light of the new FINRA registration rules,<sup>5</sup> we also suggest that the registered representative threshold not include individuals who solely maintain a permissive registration. Beginning on October 1, 2018, firms may permissively register or maintain registration of any

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<sup>5</sup> FINRA Regulatory Notice 17-30 (Oct. 2017), available at <https://www.finra.org/sites/default/files/Regulatory-Notice-17-30.pdf>.

associated person, including individuals working solely in a clerical or ministerial capacity. Accordingly, individuals not actively engaged in a firm's securities business may be registered regardless of their job function. Individuals who solely maintain a permissive registration, yet are not actively involved in a firm's securities business, should not count towards the registered representative limit for remote inspection eligibility because these individuals do not pose a risk to investors when performing their typical job functions. Furthermore, we recommend that individuals who register solely for operational requirements, but do not have direct contact with firm customers, should also be excluded from the registered representative limit as their job functions pose a similarly low risk to investors.

These crucial changes would provide firms with the option to remotely inspect a greater number of low-risk offices, such as research offices, without compromising the protection of the firms' customers. In the alternative, SIFMA requests that FINRA provide guidance on who is considered to be an "associated person" for purposes of this rule, so that persons acting solely as back office personnel do not count towards the three person limit.

Moreover, we believe that an upper bound of three registered representatives would unnecessarily limit remote inspections to very small offices, when other, slightly larger offices, engaging in similar operations with similar levels of risk, would require on-site inspections. In these cases we do not believe that the increased costs and burdens associated with conducting on-site inspections of offices with four or five registered representatives are warranted.

*4. Are there criteria for a qualifying office that should be excluded?*

SIFMA suggests that the definition of "qualifying office" be expanded to encompass a greater number of low-risk offices so that firm resources can be better allocated to monitor relatively higher-risk activities. To accomplish this stated purpose of the rule amendment, SIFMA recommends the following modifications to the definition of qualifying office.

- *Eliminate the "holding out" disqualifier in proposed Rule 3110.15(b)(2).* The same condition is currently a requirement for office locations to be excluded from the definition of "branch office" under Rule 3110(f)(2)(A). Thus, only non-branch locations would comply with the requirement that the location not be held out to the public as an office of the firm.
- *Modify the requirement under Rule 3110.15(b)(4) that no books or records are retained at the location.* We share FINRA's view of the importance of conducting on-site inspections of offices at which books and records are retained. However, improved electronic recordkeeping technology and techniques have resulted in records being stored in remotely accessible locations. As a result, many small offices "retain" electronic or printed copies of books and records (*i.e.*, fax logs or correspondence related materials) even though the original records are maintained or are accessible at larger offices. Consequently, this requirement would greatly decrease the number of offices eligible for remote inspection and would contravene the burden-reduction aims of the proposed rule. We therefore suggest that this requirement be modified to permit remote inspections of offices at which certain copies

of books and records are retained provided that originals are maintained at an office subject to on-site inspection.

- *Eliminate the requirement under Rule 3110.15(b)(5) that no customer funds or securities are handled at the location.* The management of customer funds and securities typically occurs through an electronic, firm-wide system. We recommend that FINRA exclude the operational processing of customer assets on an electronic, firm-wide system from FINRA's interpretation of "handling" customer funds or securities at a certain location. This way a greater number of low-risk offices at which operational activities occur can take advantage of remote inspections.
- *Eliminate the activity-based qualification requirements under Rule 3110.15(b)(6) in the interest of simplicity.* Firms would need to conduct a cumbersome internal analysis in order to determine if certain offices engage "solely" in the types of activities that would make offices eligible for remote inspection under this requirement. Firms may find this internal analysis uneconomical in light of the small number of offices that could potentially meet these activity-based qualifications. We therefore recommend eliminating this requirement so that firms can more appropriately allocate resources to perform a risk-based assessment for determining remote inspection eligibility.
- *Permit an office to be eligible for remote inspection if the only business conducted at such an office is investment banking activities involving institutional customers.* Investment banking offices that conduct business with institutional customers primarily perform activities such as underwriting securities and raising capital through private placements. Remote inspections, that meet the same qualitative standard as on-site inspections, are therefore appropriate for these offices because most investment banking activities are recorded in prospectuses and private placement memos, among other easily reviewable documents, and these offices conduct business with sophisticated customers, who are regularly treated differently under securities rules and regulations. For example, FINRA Rule 2111(b) provides a less stringent suitability obligation for a member or associated person dealing with an institutional customer. Investment banking offices that interact with accredited investors would not be eligible for remote inspection, as these offices pose some risk to retail investors.

SIFMA members are concerned that the abovementioned criteria as currently written unnecessarily reduce the number of offices qualifying for remote inspection because these criteria do not properly assess the level of risk associated with an office. The factors listed above in Section II.B.2, such as the complexity of products or services offered at an office and the disciplinary history of associated persons designated to an office, more precisely measure the risk associated with an office and would be appropriately considered in the implementation of the recommended risk-based assessment for determining remote inspection eligibility.

### III. CONCLUSION

SIFMA appreciates the opportunity to comment on RN 17-38. We reiterate our support for effective supervision rules that help detect and prevent misconduct in the securities industry. We believe the comments included in this letter are consistent with this support and with FINRA's effort to reduce the burden of on-site inspections without jeopardizing investor protection.

We look forward to a continuing dialogue with FINRA. If you have any questions or would like additional information, please contact Kevin Zambrowicz, Managing Director & Associate General Counsel, SIFMA, at (202) 962-7386 ([kzambrowicz@sifma.org](mailto:kzambrowicz@sifma.org)), or our counsel, Marlon Paz, at (202) 661-7178 ([paz@sewkis.com](mailto:paz@sewkis.com)).

Very truly yours,

A handwritten signature in black ink, appearing to read "K. Zambrowicz". The signature is stylized and written over a light gray rectangular background.

Kevin Zambrowicz  
*Managing Director &  
Associate General Counsel*

cc: Mary Beth Findlay, Co-Chair, SIFMA Compliance & Regulatory Policy Committee  
Ann McCague, Co-Chair, SIFMA Compliance & Regulatory Policy Committee  
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