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Industry Experience With Remote Branch Inspections

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Introduction

In 2020, the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC) and several states provided temporary relief from the operational challenges of conducting on-site branch inspections during the pandemic, allowing firms to utilize technology to fulfill their inspection obligations remotely. Now, FINRA has proposed a voluntary, three-year remote inspections pilot program to collect data to assess a potential change to FINRA Rule 3110 that would permit firms to conduct remote inspections of eligible locations on a risk basis.[1]

We support a pilot that provides stakeholders with the information they require to assess the viability of remote inspections. We believe that the events of the past two and a half years demonstrate that remote inspections are a necessary and effective risk-based supervisory tool used on a risk basis, allowing firms to focus their resources toward on-site inspections of higher-risk locations.

It is not yet clear when the SEC will rule on the pilot program and what its potential long-term impact on brokerage supervision would be. However, it is undeniable that throughout the pandemic, broker-dealers demonstrated their ability to maintain regulatory compliance in a remote environment. This survey, conducted by SIFMA and Protiviti on behalf of the securities industry, aims to resolve concerns about remote inspections during the pandemic.

The qualitative and quantitative data that we collected supports modernizing Rule 3110 to permit remote branch inspections on a risk basis. As demonstrated below, the 28 firms that participated in the survey:

- Represented a significant swath of the industry by registered representatives
- Met their inspection obligations seamlessly, conducting thousands of inspections remotely throughout the pandemic with technologies easily and affordably available
- Identified and rectified inspection findings as appropriate, with no increase in significant findings from branch inspections during the pandemic
- Focused in-person inspections on higher-risk locations as pandemic restrictions eased and conditions allowed
- Benefited from the ability to recruit and retain diverse, qualified staff essential to their supervisory programs

> "As markets have evolved, our rules have continued to evolve as well. That helps us maintain the gold standard. That helps us sustain our geopolitical edge on the world stage. I think we should do everything we can to maintain and enhance that gold standard of our capital markets."
>
> — Gary Gensler, Chair of the U.S. Securities and Exchange Commission

The advancement of our governing rule to address industry practice and investor expectations is essential to our capital markets and investor protection. However, Rule 3110, which predates the transition of the National Association of Securities Dealers (NASD) into FINRA, has not evolved effectively to address decades of changes in technology and those regulated by it.

On-site inspections are far less relevant in the current work environment, which is largely a distributed model in which physical branches maintain much less significance than they have in the past because of the widespread use of electronic books and records and central supervisory programs. Client behavior also changed. On-site client traffic, as well as employee count at the branch level, remain well below pre-COVID levels — the new normal, the industry believes.

In the industry's view, the blanket expectation for on-site branch inspections prior to the pandemic was often a mismatch for the respective location and rarely an effective use of supervisory capabilities, contrary to what some regulators assert, unless the circumstances warranted or there was a business need. The pandemic demonstrated the industry's resiliency to operate in a remote environment and surveil and supervise remotely. To date, there has not been any material change in examination findings or enforcement actions that can be attributed to a lack of on-site branch inspections, as FINRA recognized in a preliminary review, and based on available data and publications by securities regulators.

1 Proposed Rule Change to Extend the Effectiveness of Temporary FINRA Rule 3110.17, Financial Industry Regulatory Authority, https://www.finra.org/sites/default/files/2022-10/sr-finra-2022-030.pdf.

> “FINRA staff considered findings from FINRA’s examination of member firms and their branch locations that took place between 2018 and 2021. This preliminary review found no significant departures relative to pre-pandemic examination results.”
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> — FINRA, Proposed Rule Change to Adopt Supplementary Material. 18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision), File No. SR-FINRA-2022-021, 87 Fed. Reg. 50144, 50553 (Aug. 15, 2022)

Survey

Survey Methodology

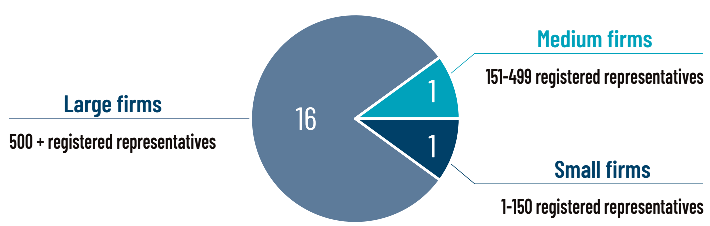
We conducted this survey with 28 firms, consisting of a sample of large, medium and small firms, as defined by FINRA, as well as different business models, from warehouses to retail and wealth management to independent firms. For the purposes of the survey, we wanted to capture a sample of the industry by the number of registered representatives because these individuals are the ones working from branch offices and other requiring inspection.

Participating firms were invited to respond to qualitative (interview) and quantitative (questionnaire) surveys. The questionnaire consisted of several questions relating to the makeup of the responding firm and its activities regarding branch inspections for the years 2017 through 2021. The time frame and questions were chosen to help us understand changes in activities and findings due to the pandemic. Of the 28 firms surveyed, 23 provided quantitative data. The results are shown in the Survey Results section.

We also interviewed chief compliance officers and other compliance executives, as well as members of their supervision teams, for qualitative insights. Participants described how remote and on-site branch inspections worked for their firms. Key takeaways from these conversations are presented in the Major Themes From the Survey section.

Survey Results

Data from more than 64%, or 18, of these firms was used in this survey. To be included, responding firms had to provide three or more relevant data points for branch inspections and branch inspection findings. As shown in the table below, this subset skews toward larger firms, which capture a critical mass of registered representatives, including financial advisors (FAs), supervisors, and others working from a firm’s home offices, branches, Offices of Supervisory Jurisdiction (OSJs), supervisory branches, and nonbranch locations such as personal residences. These 18 firms represent roughly 26% of the total number of registered representatives in the securities industry in 2021.



The quantitative survey covered information for 2017 through 2021:

- Number of branches
- Number of representatives
- Number of inspectors
- Electronic aspects of the firm
- Number of fines, violations, disciplinary actions, etc.

Some sample statistics derived from the firms that participated in this survey are below.

Survey Metric	Number Represented in Survey (2021 data)	Number From "2022 FINRA Industry Snapshot" (2021 data)
Total Firms	18 (of 28 firms interviewed)	3,394
Total Registered Representatives (RRs)	Approximately 162,300	612,457
Total Branches[2]	Approximately 21,700	149,887
Total Number of OSJs[3]	Approximately 4,000	N/A
Total Number of Inspections	Approximately 34,500	N/A

The quantitative responses regarding branch inspections and branch inspection findings are shown in the tables below.

Number of Branch Inspections

	Number of RRs (approx.)	2017	2018	2019	2020	2021
Firm 1	6,000	197	196	232	248	262
Firm 2	19,900	7,168	8,232	8,423	5,158	9,757
Firm 3	6,100	8	184	177	230	405
Firm 4	9,100	2,090	2,431	2,205	2,062	1,797
Firm 5	5,800	347	401	458	372	494
Firm 6	21,800	2,158	2,081	2,130	1,643	1,823
Firm 7	18,000	12,510	13,097	13,869	6,416	12,108
Firm 8	3,800	1,442	1,579	1,932	2,044	2,662
Firm 9	13,800	1,841	1,581	1,603	1,576	1,568
Firm 10	13,400	N/A	3,986	3,641	2,292	2,545
Firm 11	1,783	91	105	93	95	98
Firm 12	1,124	7	8	16	7	12
Firm 13	242	35	35	35	70	69
Firm 14	10,150	253	286	323	287	342
Firm 15	568	16	2	13	15	0
Firm 16	23,929	281	313	300	518	555
Firm 17	24	5	2	3	4	3
Firm 18	7,085	8	12	12	13	13

2 Two firms that provided the number of branch inspections and branch inspection findings did not provide a count of total branches.
3 Three firms that provided the number of branch inspections and branch inspection findings did not provide a count of total OSJs.

Number of Branch Inspection Findings

	Number of RRs (approx.)	2017	2018	2019	2020	2021
Firm 1	6,000	350	130	214	144	93
Firm 2	19,900	8,012	9,769	10,530	5,324	8,559
Firm 3	6,100	222	226	136	266	142
Firm 4	9,100	5,898	7,409	6,708	7,254	7,856
Firm 5	5,800	316	219	396	285	152
Firm 6	21,800	3,518	3,356	2,868	2,353	2,390
Firm 7	18,000	33,409	31,006	30,547	12,175	20,033
Firm 8	3,800	991	992	1,028	1,018	1,582
Firm 9	13,800	4,707	3,296	2,674	2,194	2,897
Firm 10	13,400	N/A	9,071	8,500	4,792	5,699
Firm 11	1,783	96	109	68	49	50
Firm 12	1,124	1	2	0	1	2
Firm 13	242	25	25	25	25	25
Firm 14	10,150	N/A	348	365	137	364
Firm 15	568	N/A	N/A	283	131	137
Firm 16	23,929	N/A	N/A	88	112	113
Firm 17	24	1	0	0	1	0
Firm 18	7,085	3	3	2	0	1

The data reveals that firms met their inspection obligations throughout the pandemic, simply conducting them by another, safer method. Firms reported conducting most of their inspections remotely due to lockdowns, travel restrictions and safety concerns, naturally, but as these concerns eased, they reported to us that they conducted some on-site examinations when the circumstances warranted or for business purposes.

Differences in the number of branch inspections conducted year over year are attributable to inspection schedules (annual versus periodic) and the number of locations that must be inspected each year. The differences in the number of findings are attributed to a variety of reasons, including but not limited to institution of a new surveillance process, particularly for any dramatic increase shown, or an increase in offices and financial advisors as was the case during the pandemic, when most people in the industry worked from home. Notably, firms reported that they did not experience an uptick in significant findings. The findings they made relate to not only compliance with rule requirements, but also firms' own policies and procedures, which may be more inclusive.

The business model and structure of a firm must also be considered. Firms of comparable size may have widely different inspection findings because of the number of branches and OSJs. One retail firm may choose to have but a few branches and OSJs containing the majority of its staff, whereas another may have hundreds or thousands of branches, and thus more findings potentially. Firms 4 and 18 exemplify this point. Firm 18 has 7,085 registered representatives, but only 13 branch offices, and thus a small number of findings, but Firm 4, with 9,100 representatives, has 7,856 findings because it has thousands more branches due to its business model.

Major Themes From the Survey

- More firms are considering allowing hybrid work arrangements, particularly because flexibility allows them to recruit and retain diverse and qualified staff essential to a well-designed supervisory program.
- Generally, firms that used electronic statements, confirmations and signatures prior to the pandemic increased their use of technology in 2020 and 2021. Culture, relative low cost, the changing business environment and customer demand were the main drivers behind this increase.
- Beside minor decreases in 2020 while firms adjusted to market conditions, the number of on-site and remote inspections was steady from 2019 to 2021. Some larger firms experienced increases in the number of remote inspections in 2021 as a matter of convenience.
- During the pandemic, firms conducted a detailed review of inspection findings and fines to determine if the negative event would have been avoided had there been an on-site inspection. Their reviews showed very few instances in which an on-site visit would have produced a different result.
- Generally, there was no notable increase in regulatory-, operational- or compliance-related events from pre-pandemic levels, which is supported by our interviews. With the additional time and resources provided by the opportunity to conduct remote inspections, firms can focus inspections on high-risk areas of conduct.
- The amount spent pre- and post-pandemic for inspections was similar.
- Firms reported consistent numbers of branch inspectors pre- and post-pandemic, backing the theory that they will not reduce personnel if inspections are conducted remotely versus on-site. Given the exponential increase in locations resulting from hybrid work, many are worried about finding enough qualified inspectors to meet the demand for on-site inspections if remote inspections are not permitted going forward.
- As a result of the pandemic, many firms enhanced their remote oversight and examination capabilities. The enhancements included increasing email sample sizes, expanding social media reviews, and enhancing machine learning tools and artificial intelligence. These enhancements will be preserved and further advanced, regardless of the ultimate rules regarding remote exams and remote supervision.
- Firms desire a change or adjustment to the branch office and OSJ definitions to better encompass the shift to a hybrid work environment.
- Most firms have full or mainly digital systems and have almost entirely eliminated paper-based systems.

The Industry Supports a Permanent Rule Change

The qualitative data we collected in interviews revealed specific insights for each firm and a clear consensus view on the industry's preferred inspection method.

The industry supports a rule change to permit a risk-based approach to remote branch inspections that provides firms discretion to employ a reasonable inspection model based on their business model, number of employees, financial advisors (FAs) and branch risk. The primary reasons for seeking this change are the efficacy of remote inspections that provide the ability to focus limited resources on higher-risk areas, change in industry business models, the widespread availability of cost-effective technologies to support a risk-based approach for firms of all sizes and resources, and the ability to recruit and retain qualified and diverse staff by offering location flexibility.

Remote Inspections Are Effective

The pandemic's forced remote work environment was a silver-lining test bed for remote inspections. Firms expressed that the pre-inspection work they perform prior to on-site examinations captures most of the inspection process and material findings, leaving the on-site visit as a relationship-building activity. Every firm reported that remotely performed work prior to the inspection remains the largest and most material aspect of branch inspections.

> In all interview instances, firms noted that **85%** to **90%** of the branch inspection is conducted before the physical on-site inspection begins.

Notably, regulators utilized a remote approach for examinations of broker-dealers throughout the pandemic and expect to do so in the future, a testament to their usefulness.

The remote approach is neither a cost-cutting measure, as some opponents may posit, nor a financial burden on smaller firms. Removal of the prescriptive on-site requirement for inspections would lead to a realignment of monitoring resources to meet the needs of firms of all sizes. Cost savings resulting from reduced travel and expenses can be reallocated to improve technologies that allow for a better risk-based approach. Simply put, it would allow firms to focus resources on higher-risk areas.

> Every firm interviewed agreed that the removal of the on-site requirements and the implementation of a **risk-based approach** would be a significant realignment of investment to higher-risk areas and in supervisory technology.

Branch Designation's Misalignment With Risk

Firms reported that a change in the industry's operating model has made branches less relevant for managing risks, necessitating a rethink of inspections generally, and more specifically on-site inspections. In addition to the fact that more representatives than ever work in a hybrid or remote capacity, client behavior has changed. Client interactions at branches significantly decreased, firms reported. This dynamic has created a divergence between the purpose of the current rule and the needs of firms and their clients. The types of risks that are mitigated by today's on-site inspections, such as signage or physical documents, are not critical risks in the current environment. The distributed nature of the industry means mandated branch visits to lower-risk locations are a perfunctory exercise to comply with an outdated rule.

A distributed environment creates challenges for firms, which reported increased risk and operational challenges visiting residences and other non-branch locations. Firms now must contemplate the privacy and safety of representatives and inspectors while conducting home inspections. This is a fundamental change from the times when branches would provide a relatively homogenous work environment and where branch managers, FAs and support staff were present. A risk-based approach with remote inspections alleviates some of the challenges.

Technology Reigns Supreme

The current work model within the industry is eclipsing the regulation and its purpose. Rule 3110 was implemented under the premise of a branch-based, paper-based industry. Continuous advancements in technologies make aspects of the rule outdated. Electronic trading, electronic signature and electronic-money movement are now industry standards, and all can be administered and monitored remotely.

The supervisory and compliance concerns now rest in the ability to monitor a representative's electronic activities rather than his or her paper-based ones. An array of technologies is available to facilitate monitoring, including location-based services, IP address, data transfer validation, email monitoring and artificial intelligence.

Moreover, the technology used for remote monitoring is also available at a reasonable price, and the ease of use of the technology is the same for a firm with 100 FAs as it is for a firm with thousands of FAs. The depth of technology is a function of culture — whether or not a firm chooses to remain paper-based with employees working at an office location — more than cost, as firms noted.

Smaller firms interviewed for this study noted that the technology to perform remote inspections is readily available and that its use does not strain their financial resources. Research conducted by Protiviti did not find any correlation between a firm's size and its technological capabilities. Business model and culture play a bigger role in determining a firm's technological sophistication, with many small firms employing the same remote technology used by larger, well-capitalized counterparts, to conduct remote inspections.

Diversity, Equity and Inclusion

Firms uniformly reported that the ability to conduct remote inspections has a direct impact on their ability to recruit and retain qualified inspectors and supervisory and compliance staff. Rules dating back to paper-based days do not currently allow firms to provide workplace flexibility for certain staff whose job locations carry regulatory implications and associated burdens. They worried that without flexibility, they would lose qualified staff essential to a well-functioning supervisory program, particularly to other industries where remote work is the norm. If the industry is to be even more diverse, equitable and inclusive, regulators must modernize certain rules where they make sense to provide greater workplace flexibility.

Conclusion

For the reasons stated throughout this narrative, the industry encourages regulators to amend regulations and provide a risk-based approach to on-site branch inspections — enabling firms to make decisions based on their size, distribution of branches, business model, remote inspection capability and the inherent risk of a branch or advisor. This survey and interview process offer adequate support for this argument and exemplifies the views of the industry at large.

FINRA Rule 3110

> "Each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."

The insights gathered from this survey bolster SIFMA's longtime advocacy. In response to FINRA's request for comments on lessons learned from the pandemic, SIFMA noted that supervision should be "risk-based, rather than location-based" and that "whereas it used to be that many such activities required a physical presence to function or be supervised appropriately, that is no longer the case."[4] Given finite resources and changes in behaviors in the industry and among investors, firms must be able to make risk-based decisions so that they can focus on the highest-risk areas. This survey and interview process offers adequate support for the argument that Rule 3110 should allow for remote inspection on a risk basis, as determined by the firm with the best understanding of its business model, culture and client base.

4 Kevin Zambrowicz, SIFMA, Comment Letter on FINRA Regulatory Notice 20-42, FINRA Seeks Comment on Lessons from the COVID-19 Pandemic (Feb. 16, 2021), https://www.finra.org/sites/default/files/NoticeComment/SIFMA%20%5BKevin%20Zambrowicz%5D%20-%20FINRA%2020-42%20COVID-19%20Impact%20SIFMA%20Comment%20Letter%20Final%20as%20Filed%20with%20FINRA%20on%20%202%2016%202021%20Zambrowicz.pdf.

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