



VIA ELECTRONIC MAIL

January 12, 2018

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

Re: Regulatory Notice 17-38 | Request for Comment on Proposal to Amend Rule 3110
(Supervision) to Provide Firms the Option to Conduct Remote Office Inspection of Offices
and Locations That Meet Specified Criteria (Notice)

Dear Ms. Mitchell:

On November 13, 2017, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on proposed amendments to FINRA Rule 3110 (Supervision) aimed at providing FINRA member firms with the option of remotely inspecting offices and locations that meet certain criteria (Proposed Amendments).¹ The Notice explains that the Proposed Amendments are designed, in pertinent part, to reduce the burden on firms stemming from on-site supervision, without increasing the risk to the investing public.²

The Financial Services Institute³ (FSI) appreciates the opportunity to comment on this important proposal. FSI notes that the Proposed Amendments were promulgated in response to member feedback. FSI commends FINRA for not only listening to feedback from its members, but also acting on it. Nonetheless, the Proposed Amendments are based upon an assumption that on-site inspections are required for all offices. That assumption is not supported by the text of FINRA's supervision rules. To the extent FINRA believes on-site supervision should be occurring more frequently, as a first step, prior to engaging in additional rulemaking, FSI suggests that FINRA consider issuing updated guidance assisting firms in determining when on-site, versus remote, inspection should occur. That guidance may leverage much of what is included in the Notice, but should not impose new requirements on firms.

We suggest that, to the extent the Proposed Amendments are adopted, they be narrowly tailored to achieve the objective stated in the Notice and should be clarified in several respects. First, we suggest that the definition of qualifying office not be conditioned on the number of associated persons in the location. Second, we suggest FINRA clarify: (i) the circumstances under

¹ See FINRA Regulatory Notice 17-38 (November 13, 2017).

² *Id.* at p. 3.

³ The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

which a qualifying office would be deemed to be handling customer funds and securities; and (ii) whether the requirement that firm business be conducted *solely* using the firm's systems or platforms, means that associated persons in qualifying offices cannot use personal, or other email, even if the firm has policies, procedures and/or technology in place to capture, maintain and otherwise supervise these communications. We discuss these suggestions in more detail below.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.⁴ These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).⁵

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate \$48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly \$6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.⁶

Discussion

I. Background

FINRA asserts that the Proposed Amendments would provide member firms with the option to conduct remote, in lieu of on-site, office inspections of certain "qualifying offices." This would offset the burden associated with on-site inspections of remote offices "in limited circumstances that would not result in a diminution in investor protection."⁷ In limiting the circumstances under

⁴ Cerulli Associates, Advisor Headcount 2016, on file with author.

⁵ The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

⁶ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

⁷ See Regulatory Notice 17-38 at p. 3 (November 13, 2017).

which remote office inspections would be appropriate, the Proposed Amendments define a qualifying office as a location:

- where no more than three associated persons are conducting business,
- that is not held out the public as a firm office,
- that does not maintain the books and records the firm is required to maintain and preserve under applicable federal securities laws and/or FINRA rules,
- that does not handle customer funds or securities,
- where business, including electronic communications, are conducted through firm-approved systems or platforms, and
- in which the registered persons at the location are not subject to statutory disqualification and do not have a “disciplinary history,” as that phrase is defined in FINRA Rule 3120(a)(3).⁸

Further, other locations, such as those subject to annual inspections under FINRA Rule 3110(c)(1)(A) are similarly excluded from the definition of qualifying office. The Proposed Amendments would require firms wishing to avail themselves of this option to have written policies and procedures reasonably designed to ascertain if a location is appropriate for virtual inspection as a qualifying office.⁹

II. Where Reasonable, Firms May Already Conduct Remote Inspections

A. We Believe FINRA Rules Already Provide Firms With the Option to Conduct Remote Office Inspections

As stated elsewhere herein, FINRA appears to maintain that the Proposed Amendments provide firms with an option to conduct remote office inspections of certain locations. That presupposes that remote office inspections are not currently an option; and, conversely, that on-site inspections are currently required. However, neither appears to be accurate. In fact, the Notice, ostensibly, acknowledges this by stating that: “FINRA has *interpreted* the rules to require that inspections take place on-site, irrespective of the type of office”.¹⁰ In support of this assertion, FINRA points to guidance formerly propounded in Regulatory Notice 11-54 (FINRA and the SEC Issue Joint Guidance on Effective Policies and Procedures for Broker-Dealer Branch Inspections).¹¹ Regulatory Notice 11-54 notes the value of on-site intelligence and creates an assumption that inspections would be conducted on-site. However, that guidance, which was issued over six years ago, is aged and does not account for the vast technological advances during the intervening time-period.

Even so, it is fundamentally important to note that Regulatory Notices, and other interpretive advice issued by FINRA are guidance and do not rise to the level of rules or requirements. FINRA Rule 3110, the governing rule, only requires that “[e]ach member ... conduct a review... reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable FINRA

⁸ See Proposed Rule 3110.15(b)(1)- 7).

⁹ See Proposed Rule 3110.15(a).

¹⁰ See Regulatory Notice 17-38 at p. 10 (November 13, 2017).

¹¹ *Id.* at p. 10 fn. 10.

rules”.¹² Even Supplementary Material Rule 3110.12, which explicitly addresses remote office locations, provides only that:

Each member shall establish and maintain supervisory procedures that must take into consideration, among other things, the firm's size, organizational structure, scope of business activities, number and location of the firm's offices, the nature and complexity of the products and services offered by the firm, the volume of business done, the number of associated persons assigned to a location, the disciplinary history of registered representatives or associated persons, and any indicators of irregularities or misconduct (i.e., "red flags"), etc. The procedures established and reviews conducted must provide that the quality of supervision at remote locations is sufficient to ensure compliance with applicable securities laws and regulations and with FINRA rules. A member must be especially diligent in establishing procedures and conducting reasonable reviews with respect to a non-branch location where a registered representative engages in securities activities. Based on the factors outlined above, members may need to impose reasonably designed supervisory procedures for certain locations or may need to provide for more frequent reviews of certain locations.

Thus, FINRA rules, in their current form, impose an obligation on FINRA member firms to assess the risk profile of each office location where securities business is conducted, have adequate written supervisory procedures in place based upon that risk profile, and to conduct reasonable reviews of each office location. FSI's members believe that virtual reviews may very well meet the reasonableness test. Moreover, if a firm determines that virtual reviews are reasonable, FINRA will have the opportunity to review that determination during the firm's cycle examination.

To the extent that FINRA staff believed that on-site inspections were required by FINRA's supervision rules, FINRA could have clarified this point in the new consolidated supervision rules, which were approved in 2014 – after the publication of Regulatory Notice 11-54.¹³ Another important consideration is that FINRA Rule 3110.03(e) specifically requires an on-site principal for Offices of Supervisory Jurisdiction and explains that principals must “have a physical presence, on a regular and routine basis.” Thus, in drafting the current iteration of the rules, it appears that FINRA staff considered the circumstances in which on-site supervision should be required. Even so, on-site inspections of remote offices were not included in the final rule. Thus, to now, render it a requirement through rulemaking that attempts to establish remote inspections as an option, is confusing to the industry.

B. This Subject Matter Should be Addressed Through Guidance In lieu of Additional Rulemaking

As explained above, FINRA rules do not require on-site office inspections. Therefore, in lieu of instituting Proposed Amendments that are predicated upon a non-existent requirement, the industry would be better served with updated guidance designed to assist members in

¹² See FINRA Rule 3110 (c)(1).

¹³ See Regulatory Notice 14-10 (SEC Approves New Supervision Rules) (March 2014).

determining best practices for conducting remote office inspections. That guidance may include factors firms should consider in determining whether remote inspection of a particular location is reasonable in light of the considerations enumerated in Rule 3110.12 and should leverage much of the helpful guidance set forth in the Notice.

III. Modifications To The Proposed Amendments Will More Effectively Achieve The Stated Regulatory Objective

A. Introduction

FSI maintains that the Proposed Amendments should be addressed through additional guidance as opposed to rulemaking. However, to the extent that the Proposed Amendments are approved, we believe they should be modified to be narrowly tailored to specifically address the objectives set forth in the Notice, i.e., alleviating firms' burden in respect of on-site inspections of remote offices without undermining investor protection.¹⁴ In meeting this regulatory objective, FSI suggests that any Proposed Amendments should focus:

- on the nature of the activities conducted at the location,
- whether these activities pose a risk to the investing public and, if so,
- whether on-site supervision will yield access to any additional intelligence that would not be accessible to the firm via remote inspection.

Moreover, the Proposed Amendments should be narrowly tailored to address those considerations.

B. The Proposed Rules Should be More Narrowly Tailored

- i. Proposed Rule 3110.15(b)(1) Should be Modified so that Firms May Consider the Number of Associates in Determining Whether Remote Inspection Constitutes Reasonable or Adequate Supervision*

Under proposed rule 3110.15 (b) (1), no more than three associated persons could conduct business from a qualifying office. Throughout Rule 3110, the number of associated persons is noted as a factor that should be considered as firms develop their supervisory systems. However - presumably recognizing that the impact of this consideration may vary by firm, locations and the nature of the business conducted - Rule 3110 does not address static numbers.

Proposed rule 3110.15 (b) (1), however, does and sets the number at three associated persons. That criteria appears to be a bit arbitrary. In fact, it is unclear how three associated persons without a disciplinary history would not pose a greater risk to the investing public than, for example, four associated persons without a disciplinary history. Thus, FSI suggests eradicating this requirement from the Proposed Amendments. Instead, firms could undergo a risk based analysis to determine if, based upon the number of associated persons working in a particular office, the technology utilized by the firm, and other factors, remote office inspection would be reasonable.

¹⁴ See Regulatory Notice 17-38 at p. 3 (November 13, 2017).

ii. *Proposed Rule 3110.15(b)(3) Should be Modified to Exclude Electronic Communications Transmitted by Other Means but Captured by the Firm's Systems or Platforms*

Under proposed rule 3110.15 (b) (3), associated persons located in a qualifying office may conduct business on the member's behalf "solely through" a firm approved systems and platforms. As proposed, proposed rule 3110.15 (b) (3) may have the unintended consequences of being overly inclusive. At bottom, the fundamental regulatory issue is not whether business is conducted through a firm approved system or platform. Rather, the fundamental regulatory issue is whether the firm is able to capture, monitor and preserve records related to this business. For instance, in the case of emails, many firms permit associated persons to use outside email addresses, so long as the firm has policies, procedures and/or technology in place to capture, maintain and supervise these communications. Thus, FSI suggests that proposed rule 3110.15 (b) (3) be modified such that associated persons in qualifying offices may use other systems; so long as the firm has the technical capabilities to monitor, maintain and preserve the communications.

iii. *Proposed Rule 3110.15 (b)(5) Should Be Clarified As to What Constitutes "Handling" Customer Funds and Securities*

Under proposed rule 3110.15 (b) (5), no customer funds or securities may be handled in a qualifying office. It is unclear if this prohibition would extend to offices required to promptly transmit customer checks to the main office. While these offices may, from time to time, receive customer checks, they do not hold onto them for any prolonged length of time. Instead, they record receiving the check and, thereafter, promptly forward it to the main office – a requirement typically imposed by the firm's written supervisory procedures. Records related to these checks are often maintained electronically. In these cases, there is little regulatory value in requiring on-site supervision of these locations; provided these offices are able to meet the remaining requirements of a qualifying office. Thus, proposed rule 3110.15 (b) (5), should be further amended so that it does not have the unintended consequences of preventing those offices from availing themselves of option of conducting remote office inspections.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,



Vice President, Regulatory Affairs & Associate General Counsel