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VOICE OF INDEPENDENT
FINANCIAL SERVICES
FIRMS AND INDEPENDENT
FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

November 30, 2018

Ms. Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Report on Technology Based Innovations for Regulatory Compliance in the Securities Industry

Dear Ms. Asquith:

In September 2018, the Financial Industry Regulatory Authority, Inc. (FINRA), published a thirteen-page report recognizing the benefits of regulatory compliance technology (RegTech), while reminding firms of their regulatory responsibilities when employing that technology (Report).¹ FINRA published this Report to contribute to the continuing RegTech dialogue and, more specifically, to solicit public comments regarding the potential implications of emerging RegTech and/or any additional resources, new rule proposals or proposed rule amendments FINRA should consider.² FSI commends FINRA for its desire to support innovation in financial technology³ and appreciates the opportunity to comment on the Report.

RegTech has the ability to diminish the differential value between: i) information derived from remote office inspections; and ii) information derived from onsite office inspections. Thus, FSI encourages FINRA to revisit its proposed amendments to FINRA Rule 3110 and consider expanding the circumstances under which firms may conduct remote office inspections. Further, as noted in the Report, many firms are outsourcing compliance functions to RegTech vendors.⁴ Accordingly, FINRA should consider updating its regulatory framework to account for the industry's increasing reliance on outside technology vendors and to provide firms with greater clarity concerning their obligations when relying on these third-party vendors. Finally, consistent with FINRA Rule 3110, firms that have a reasonable supervisory system in place, should not be subject to regulatory liability for harm or loss resulting solely from a third-party vendor's acts and omissions.

¹ See, generally, FINRA Report on Technology Based Innovations for Regulatory Compliance in the Securities Industry (Sept. 2018), available at http://www.finra.org/sites/default/files/2018_RegTech_Report.pdf (Report).

² *Id.* at p. 7.

³ *Id.* at p. 11.

⁴ *Id.* at p. 8.

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.⁵ These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).⁶

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.⁷

Discussion

FSI appreciates the opportunity to comment on the Report. While the Report is focused on RegTech, RegTech presents certain opportunities and challenges, which should also be addressed. In particular, as alluded to above, RegTech presents the opportunity for firms to conduct remote office inspections that gather intelligence, with substantially equivalent value, to the intelligence gathered from onsite inspections. Nonetheless, technology innovation, and increased reliance on technology, means that firms are finding themselves with more vendor relationships to manage and with little substantive guidance advising them how to so in a manner satisfactory to regulators.

⁵ Cerulli Associates, Advisor Headcount 2016, on file with author.

⁶ 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.

⁷ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

I. FINRA Should Consider Expanding the Definition of “Qualifying Office” Propounded in its Remote Office Inspection Proposal

A. FINRA Should Consider Whether Emerging Technology Diminishes the Differential Value Between Onsite and Remote Inspections; If It Does, FINRA Should Revisit Commenters’ Suggestions for Allowing Remote Office Inspections in Additional Circumstances

In light of emerging technology, FINRA should consider revisiting FINRA Regulatory Notice 17-38 (RN 17-38) and, more specifically, should look for opportunities to incorporate commenters’ suggestions for expanding the circumstances under which firms may elect to conduct remote office inspections. By way of background, FINRA published RN 17-38 on November 13, 2017, requesting public comment on proposed amendments to FINRA Rule 3110 (Supervision).⁸ The proposed amendments were intended to reduce the burden on firms stemming from onsite supervision, without increasing the risk to the investing public.⁹ Referencing Regulatory Notice 11-54, FINRA noted that its rules have been interpreted to require onsite inspections of all firm offices.¹⁰ Along those lines, Regulatory Notice 11-54 guides FINRA members to conduct onsite office inspections, in part, because gathering onsite intelligence allows firms to both supplement, and validate, their office surveillance.¹¹

However, the rule amendments proposed in RN 17-38, if adopted, would create a carve out from the requirement that firms conduct onsite office inspections.¹² In particular, the proposed amendments would allow firms to remotely inspect offices that satisfy the definition of “qualifying offices.”¹³ The proposal defined a qualifying office as one that met certain enumerated conditions, including having no more than three associated persons conducting business at the location, no customer funds and or securities could be handled at the location and the location could not be held out to the public as an office of the firm.¹⁴ RN 17-38 also contained a number of other conditions that would have to be met for a location to constitute a qualifying office.¹⁵

Many FSI member firms reported that they would, likely, continue to conduct onsite office inspections, even if they are afforded the option to conduct remote inspections. Other FSI members, however, have indicated that the ability to conduct remote office inspections would allow them to reallocate their resources to other compliance areas that may pose a greater risk. That reallocation would increase investor protection. In addition, as noted in RN 17-38, the opportunity to conduct remote office inspections may reduce the burden of onsite inspections for firms¹⁶ and, thus, other firms have reported that benefit as another basis for desiring that option.

Consequently, FSI responded to RN 17-38 explaining that, while FINRA rules have been interpreted to require onsite inspection of branch offices, the text of FINRA Rule 3110 does not require onsite office inspections.¹⁷ FSI also noted that certain aspects of the definition for qualifying office seemed somewhat arbitrary, such as limiting the number of associated persons

⁸ See FINRA Regulatory Notice 17-38 (Nov. 13, 2017) at p. 3.

⁹ *Id.*

¹⁰ *Id.* at p. 2.

¹¹ See FINRA Regulatory Notice 11-54 (Nov. 2011) at p. 2.

¹² See, generally, FINRA Regulatory Notice 17-38.

¹³ *Id.*

¹⁴ *Id.* at 4.

¹⁵ *Id.*

¹⁶ *Id.* at p. 3.

¹⁷ See Letter dated January 12, 2018 from Robin Traxler, Vice President, Regulatory Affairs & Associate General Counsel, Financial Services Institute to Jennifer Piorko Mitchell, Office of the Corporate Secretary, FINRA (FSI Response Letter) at p. 3.

conducting business at the location to three, versus establishing the limit at four or, even, ten. Most relevant, however, FSI commented that Regulatory 11-54 "... is aged and does not account for the vast technological advances during the intervening time-period."¹⁸

Based on the age of the guidance interpreting FINRA rules to require onsite supervision, the nature of RegTech developments and firms' increased use and reliance on RegTech, FSI suggests that FINRA revisit the comments received in response to RN 17-38. As FINRA is revisiting these comments, it should consider whether emerging RegTech can, or does, diminish the differential value between onsite and remote intelligence. If it does, or can, FSI encourages FINRA to take a second look at commenters' suggestions for expanding the scope of the proposed definition of qualifying office. FSI further encourages FINRA to determine whether it can adopt some of those recommendations, without compromising investor protection or market integrity.

An exemption from onsite supervision that is predicated on RegTech capability, should have conditions. To that end, the final amendments should condition a firm's ability to conduct remote office inspections, on the firm's ability to replace onsite inspection with technology, or other resources, that can remotely elicit information that has substantially equivalent value as the information that could be elicited from an onsite office inspection. Notably, the information need not be the same. It only needs to have substantially equivalent value.

B. Expanding the Circumstances Under Which Firms Would Be Allowed to Conduct Remote Office Inspections May Support Firms' Efforts to Achieve a Representative and Inclusive Workforce

FINRA noted that technology has increased the prominence of remote location and flexible work arrangements.¹⁹ Thus, another foreseeable consequence of broadening the circumstances under which firms may conduct remote office inspections is that firms will be able to allow more remote and flexible work arrangements, without assuming the cost and compliance burden attributable to onsite inspections of those locations. Increased remote and flexible work arrangements create more opportunities to foster a representative and inclusive financial industry, including achieving greater cross-generational representation.

For example, millennials, who constitute the majority of the workforce, are seeking flexible work arrangements.²⁰ Working parents, particularly working mothers, may also benefit from an increase in these arrangements.²¹ The burden of having to perform onsite inspections of these remote offices, particularly those locations where the worker may only work part-time, or on a non-traditional schedule, may dissuade firms from allowing these arrangements and, accordingly, impair firms' efforts to achieve a truly representative workforce.

¹⁸ *Id.*

¹⁹ See FINRA360 Progress Report, Operations - Remote Branch Office Inspections, available at <https://www.finra.org/about/finra360-progress-report/remote-branch-office-inspections>.

²⁰ See *Workplace Flexibility for Millennials: Appealing to a Valuable New Generation*, Tess C. Taylor PHR SHRMCP CPCP (Oct. 24, 2018), available at <https://www.adp.com/spark/articles/2018/10/workplace-flexibility-for-millennials-appealing-to-a-valuable-new-generation.aspx#>.

²¹ See *The Rise of Women Who Work Remotely: Flexibility is the Future*, Behere, (Oct. 23, 2017), available at [https://gobehere.com/rise-women-work-remotely/\(explaining that, \[e\]mployers who embrace flexibility and invest in women will see the benefits through their employees and their businesses.\)](https://gobehere.com/rise-women-work-remotely/(explaining%20that,%20[e]mployers%20who%20embrace%20flexibility%20and%20invest%20in%20women%20will%20see%20the%20benefits%20through%20their%20employees%20and%20their%20businesses.)).

II. Regulatory Obligations Arising from Outsourced Technology-Related Functions Should Be Clarified and Updated

A. FINRA Should Clarify or Update Firm's Vendor Management Regulatory Obligations to Account for Broker Dealers' Increasing Reliance on Technology

The Report focuses on RegTech.²² However, one of the more universal regulatory challenges stemming from firms' overall, rapidly increasing, reliance on various forms of technology (not just RegTech) relates to outsourcing and vendor management. Regarding the, undeniable, impact of technology on outsourcing, the Report notes that, "[g]iven the rapid development of RegTech tools and services, many broker-dealers are choosing to outsource discrete compliance and reporting functions (e.g., customer identification, AML transaction monitoring, fraud surveillance, etc.) to RegTech vendors."²³

FINRA relies on Notice to Members 05-48 (NTM 05-48) to articulate the impact of outsourcing to RegTech vendors on firms, as well as to articulate firms' responsibilities when they do so.²⁴ Drawing from NTM 05-48, FINRA reminds firms that outsourcing regulatory responsibilities to third-party vendors does not relieve the firm of its regulatory responsibility for, or its regulatory liability related to, the outsourced activities.²⁵ The Report also provides a non-exhaustive list of things firms should consider when utilizing third-party RegTech vendors.²⁶

While NTM 05-48 is helpful and, in many ways, continues to be relevant, that guidance was published thirteen years ago.²⁷ It was drafted, and propounded, during a time when RegTech was neither as advanced as it is today, nor was it as prevalently utilized in the industry. Thus, applying that guidance to today's iteration and usage of RegTech proves difficult, at best. Equally as important, NTM 05-48 does not contain enough detail to provide FINRA members with adequate notice regarding their vendor management responsibilities in respect of today's advancing technology and firm's increasing number of vendor relationships.

In particular, absent from that guidance is vital information such as, what constitutes an appropriate due diligence analysis by a member firm; or how firms are expected to implement and execute supervision over third-party offsite providers. The guidance also fails to address a firm's liability, if any, where: i) that firm has reasonable vendor management policies and procedures in place; ii) the firm has followed those policies and procedures, and, yet iii) harm or loss results that is solely caused by an act or omission of the third-party technology vendor. These are important considerations not only for supporting RegTech, but also in supporting firms in responsible implementation and use of RegTech, as well as other forms of emerging technology. Otherwise, firms are left to grapple with these issues in the dark by attempting to apply guidance to circumstances that were not complemented at the time the guidance was published. Firms are also left to deal with the resulting regulatory liability, i.e., enforcement action.

B. FINRA Should Organize a Working Group to Solicit Feedback Prior to Publishing Vendor Management Rules, Rule Amendments or Updated Guidance

As noted above, the Report's primary focus is on RegTech. Thus, even though vendor management is an important issue to FSI members and industry stakeholders, those stakeholders

²² See, generally, Report.

²³ See Report at p. 8.

²⁴ *Id.* at p. 8-9.

²⁵ *Id.*

²⁶ *Id.*

²⁷ See, generally, Notice to Members 05-48 (July 2005).

may not view this Report as an opportunity to comment on vendor management. FINRA should, therefore, consider creating a working group, consisting of companies who offer RegTech to financial services firms, as well as compliance, operations, financial and technology professionals who are associated with, or employed by, FINRA member firms.²⁸ The working group should be representative of the industry by including firms of various sizes and various business models, including being representative of independent broker dealers.

FINRA should solicit information from the working group concerning various issues impacting RegTech outsourcing and vendor management, including, for example:

- The latest developments in RegTech,
- RegTech trends, expected advancements and the direction of RegTech,
- RegTech vendors' appetites for including certain contractual provisions recommended by regulators,
- The impact of altered contractual terms, if any, on RegTech pricing,
- Ways of increasing small firm access to RegTech,
- Firms' feedback on best practices in vendor management, and
- Firms' feedback on vendor management challenges encountered in both centralized, and in decentralized, supervisory structures.

Once FINRA has solicited feedback from the working group, FINRA should consider whether it should incorporate those suggestions into its regulatory framework and, if so, whether the suggestions should be incorporated through a new rule, rule amendment, by issuing updated member guidance or through a combination of the three. FSI suggests that FINRA allow public feedback on: i) the suggestions; ii) the manner in which the suggestions should be incorporated (i.e., through a proposed rule or by issuing updated or new regulatory guidance); and iii) any draft guidance, before it is finalized.

C. Any Rule, Rule Amendment or Updated Vendor Management Guidance Should Limit Firm's Regulatory Liability for Acts or Omissions of Third Party Vendors

FINRA Rule 3110 provides, in pertinent part, that [e]ach 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. Final responsibility for proper supervision shall rest with the member."²⁹ Thus, it is clear that the ultimate responsibility for supervision lies with members and not with their vendors. However, it is also clear that, to comply with FINRA Rule 3110, a member's supervisory system need not be failproof. Instead, it need only be reasonable.

That said, even the most reasonable and well-managed vendor relationship may result in harm or loss. At times, that harm or loss may be the sole result of acts or omissions on the part of a third-party technology vendor. In those cases, while there is an understandable urge to assign blame, that blame should not be attributed to the firm. Thus, any proposed rule, rule amendments or updated guidance should state, with specificity, that a FINRA member will not have regulatory liability where:

²⁸ FSI understands that FINRA has an *ad hoc* FinTech Industry Committee. However, the recommended scope of the suggested working group seems to be different than the intended scope of FinTech Industry Committee. Even so, it would appear reasonable for the working group to report its findings to the FinTech Industry Committee with recommendations for next steps.

²⁹ See FINRA Rule 3110 (a) (emphasis added).

- that member has reasonable vendor management policies and procedures in place; and
- the member has followed those policies and procedures, and, yet
- harm or loss resulted; and
- that harm or loss was, solely, caused by an act or omission by a third-party vendor.

This recommendation comports with both the spirit, and the text, of FINRA Rule 3110's requirement that a firm's supervisory system be reasonable, as opposed to it requiring that the system be infallible.

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.

A handwritten signature in blue ink that reads "Robin Traxler". The signature is written in a cursive style with a large, sweeping initial "R" and a long horizontal line extending from the end of the name.

Vice President, Advocacy Policy & Associate General Counsel