

**FOR FURTHER INFORMATION CONTACT:**

Sean C. Robinson, 202–268–8405.

**SUPPLEMENTARY INFORMATION:** The United States Postal Service® hereby gives notice that, pursuant to 39 U.S.C. 3642 and 3632(b)(3), on April 26, 2023, it filed with the Postal Regulatory Commission a *Request of the United States Postal Service to Add Priority Mail, First-Class Package Service & Parcel Select Contract 8 to Competitive Product List*. Documents are available at [www.prc.gov](http://www.prc.gov), Docket Nos. MC2023–139, CP2023–141.

**Sarah Sullivan,**

*Attorney, Ethics & Legal Compliance.*

[FR Doc. 2023–09442 Filed 5–3–23; 8:45 am]

**BILLING CODE 7710–12–P**

**POSTAL SERVICE**

**Product Change—Priority Mail Express, Priority Mail, First-Class Package Service, and Parcel Select Service Negotiated Service Agreement**

**AGENCY:** Postal Service™.

**ACTION:** Notice.

**SUMMARY:** The Postal Service gives notice of filing a request with the Postal Regulatory Commission to add a domestic shipping services contract to the list of Negotiated Service Agreements in the Mail Classification Schedule’s Competitive Products List.

**DATES:** *Date of required notice:* May 4, 2023.

**FOR FURTHER INFORMATION CONTACT:**

Sean Robinson, 202–268–8405.

**SUPPLEMENTARY INFORMATION:** The United States Postal Service® hereby gives notice that, pursuant to 39 U.S.C. 3642 and 3632(b)(3), on April 28, 2023, it filed with the Postal Regulatory Commission a *USPS Request to Add Priority Mail Express, Priority Mail, First-Class Package Service, and Parcel Select Service Contract 116 to Competitive Product List*. Documents are available at [www.prc.gov](http://www.prc.gov), Docket Nos. MC2023–140, CP2023–143.

**Sarah Sullivan,**

*Attorney, Ethics & Legal Compliance.*

[FR Doc. 2023–09437 Filed 5–3–23; 8:45 am]

**BILLING CODE 7710–12–P**

**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34–97398; File No. SR–FINRA–2023–007]

**Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Adopt Supplementary Material .18 (Remote Inspections Pilot Program) Under FINRA Rule 3110 (Supervision)**

April 28, 2023.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b–4 thereunder,<sup>2</sup> notice is hereby given that on April 14, 2023, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

**I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change**

FINRA is proposing to amend FINRA Rule 3110 (Supervision) to adopt a voluntary, three-year remote inspections pilot program to allow member firms to elect to fulfill their obligation under paragraph (1) to Rule 3110(c) (Internal Inspections) by conducting inspections of some or all branch offices and locations remotely without an on-site visit to such office or location, subject to specified terms. As detailed below, the key terms would include, among others: (1) a requirement for a firm to conduct and document a risk assessment for inspecting an office or location remotely and providing a non-exhaustive list of factors to consider for this risk assessment; (2) criteria that would make a member firm ineligible to participate in the program; (3) conditions a member firm must satisfy before becoming a pilot program participant relating to the firm’s recordkeeping system, and surveillance and technology tools; (4) criteria that would make ineligible for remote inspection certain member firm offices or locations; (5) conditions a member firm’s office or location must satisfy to be able to undergo a remote inspection relating to electronic communications, correspondence, and books and records; (6) a requirement that a participating firm provide FINRA specified data and

information on a quarterly basis; and (7) authorization for FINRA to determine in the public interest that a firm is no longer eligible to participate in the proposed program.

The proposed Remote Inspections Pilot Program would not change the current requirements under Rule 3110(c). Instead, the proposed program would provide firms the flexibility to satisfy their Rule 3110(c)(1) inspection obligation with or without an on-site visit to the office or location, subject to the proposed terms described herein. FINRA believes that proposed Rule 3110.18, on balance, preserves investor protection objectives through the proposed safeguards while also providing FINRA the opportunity to gauge the effectiveness of remote inspections as part of a modernized, reasonably designed supervisory system that reflects the current work environment and availability of technologies that did not exist when the on-site inspection originally was conceived.

Subject to further clarifications to proposed Rule 3110.18 as described below, the terms of the proposed rule change herein are largely similar to File No. SR–FINRA–2022–021 filed in July 2022,<sup>3</sup> then amended in December 2022<sup>4</sup> (together, the “2022 Remote Inspections Pilot Program Rule Filing”). FINRA withdrew File No. SR–FINRA–2022–021 on April 11, 2023 to consider whether more safeguards and clarifications to the filing would be appropriate in response to concerns raised by commenters.<sup>5</sup> This proposed rule change is organized in five sections: (1) the background, which provides a historical overview of Rule 3110(c), and discusses the environmental changes that have occurred over the years relating to technology and the workplace; (2) FINRA’s observations of evolving inspection practices; (3) the emergence of remote inspections as a new approach to evaluation under Rule 3110(c)(1); (4) a description of the terms of the proposed rule change; and (5) an overview of FINRA’s monitoring and compliance with proposed Rule 3110.18.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal

<sup>3</sup> See Securities Exchange Act Release No. 95452 (August 9, 2022), 87 FR 50144 (August 15, 2022) (Notice of Filing of File No. SR–FINRA–2022–021) (“Initial Rule Filing”); see also Exhibit 2a.

<sup>4</sup> See Securities Exchange Act Release No. 96520 (December 16, 2022), 87 FR 78737 (December 22, 2022) (Notice of Partial Amendment No. 1 to File No. SR–FINRA–2022–021) (“Amended Rule Filing”); see also Exhibit 2b.

<sup>5</sup> See Exhibit 2d.

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b–4.

office of FINRA and at the Commission's Public Reference Room.

## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

##### (I) Background

##### A. Overview

The responsibility of firms to supervise their associated persons is a critical component of broker-dealer regulation.<sup>6</sup> Member firms must supervise all of their associated persons, regardless of their location, compensation or employment arrangement, or registration status.<sup>7</sup> Rule 3110 requires a member, regardless of size or type, to have a supervisory

<sup>6</sup> See generally SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) ("SLB 17") (SEC guidance on remote office supervision), <https://www.sec.gov/interps/legal/mrslb17.htm>; and *Regulatory Notice* 11-54 (November 2011) ("Notice 11-54") (joint SEC and FINRA guidance on effective policies and procedures for broker-dealer branch inspections).

<sup>7</sup> This obligation is consonant with Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act. Section 15(b)(4)(E) provides that: "Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds . . . that such broker or dealer . . . or any person associated with such broker or dealer . . . has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision." 15 U.S.C. 78o(b)(4)(E). Section 15(b)(6)(A)(i) parallels Section 15(b)(4)(E) and provides for the imposition of sanctions against persons associated with a broker or dealer that violates those statutes, rules and regulations enumerated in Section 15(b)(4)(E) and other specified subparagraphs under Section 15(b)(4). 15 U.S.C. 78o(b)(6)(A).

system for the activities of its associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules, and sets forth the minimum requirements for such supervisory system.<sup>8</sup> The internal inspection obligation under Rule 3110(c) is one component of such system.

Before the adoption of Rule 3110(c) in its current form as described below, FINRA's (then NASD's) Rules of Fair Practice<sup>9</sup> required a member firm to review the activities of each office including the periodic examination of customer accounts to detect and prevent irregularities and abuses and at least an annual inspection of each OSJ.<sup>10</sup> Subsequently, FINRA expanded the review requirement to include not only the activities of each office, but also the businesses in which a member firm engages.<sup>11</sup>

The expanded review requirement included, among other things, an inspection of branch offices in accordance with a schedule as set forth in the member's supervisory procedures.<sup>12</sup> This expansion was intended to address concerns about the adequacy of ongoing supervision and regular examination of associated persons engaged in the offer and sale of securities to the public at locations away from a member firm's office.<sup>13</sup> FINRA guidance during this period of supervisory change focused on the need for the effective supervision of the securities-related activities of "off-site representatives," and advised firms of the importance of not only reviewing their supervisory systems and procedures to ensure that they were current and adequate, but also conducting inspections to determine whether these systems and procedures were being followed.<sup>14</sup> Further, the guidance advised firms that an inspection should include, among other

<sup>8</sup> See Rule 3110(a).

<sup>9</sup> Then NASD adopted its Rules of Fair Practice when it was founded in 1939 under provisions of the 1938 Maloney Act amendments to the Exchange Act.

<sup>10</sup> See *Notice to Members* 87-41 (June 1987) ("Notice 87-41") (setting forth the proposed rule text changes to Article III, Section 27 of the NASD Rules of Fair Practice for the review and annual inspection requirement, among other provisions).

<sup>11</sup> See *Notice to Members* 88-84 (November 1988) ("Notice 88-84").

<sup>12</sup> See *Notice* 88-84. By 2004, the requirement to inspect a branch office in accordance with a regular schedule as set forth in the member's supervisory procedures was replaced by mandatory inspection cycles as set forth under Rule 3110(c)(1). See *Notice to Members* 04-71 (October 2004).

<sup>13</sup> See *Notice* 88-84.

<sup>14</sup> See *Notice to Members* 99-45 (June 1999) ("Notice 99-45").

things, a "review of any on-site customer account documentation and other books and records, meetings with individual registered representatives to discuss the products they are selling and their sales methods, and an examination of correspondence and sales literature."<sup>15</sup>

The guidance about the effective supervision of "off-site representatives" and what an inspection entailed was pragmatic at a time when business activities were conducted primarily using paper documents<sup>16</sup> that were created and stored locally at an office or location; registered persons were interacting with their customers largely through in-person meetings, paper-based correspondence transmitted through the postal service, and landline telephone calls; and supervisory personnel were conducting supervision through manual reviews of paper files (e.g., exception reports bearing a supervisor's handwritten comments and initials or signature). In that environment, the best practice to determine whether the firm's supervisory system and procedures were being followed was through having firm compliance personnel visit the office or location. This practice has remained the prevailing means to satisfy the inspection obligation under Rule 3110(c)(1).

Currently, Rule 3110(c) sets forth three main requirements for inspections. First, an inspection of an office or location must occur on a designated frequency. The periodicity of the required inspection varies depending on the classification of the location or the nature of the activities that take place: OSJs and supervisory branch offices must be inspected at least annually;<sup>17</sup> non-supervisory branch offices, at least every three years;<sup>18</sup> and non-branch locations, on a periodic schedule, presumed to be at least every three years.<sup>19</sup> Second, a member must retain a written record of the date upon which each review and inspection occurred, reduce a location's inspection to a written report and keep each inspection report on file either for a minimum of

<sup>15</sup> See *Notice to Members* 98-38 (May 1998) ("Notice 98-38") and *Notice* 99-45; see also *Notice to Members* 86-65 (September 1986) ("Notice 86-65").

<sup>16</sup> Paper-based documents included, for example, customer account opening documents; correspondence with customers; marketing materials; communications from registered persons to the firm; order tickets; checks received and forwarded; and fund transmittal records.

<sup>17</sup> See Rule 3110(c)(1)(A).

<sup>18</sup> See Rule 3110(c)(1)(B).

<sup>19</sup> See Rules 3110(c)(1)(C) and 3110.13 (General Presumption of Three-Year Limit for Periodic Inspection Schedules).

three years or, if the location's inspection schedule is longer than three years, until the next inspection report has been written.<sup>20</sup> If applicable to the location being inspected, the inspection report must include the testing and verification of the member's policies and procedures, including supervisory policies and procedures, in specified areas.<sup>21</sup> Third, to prevent compromising the effectiveness of inspections due to conflicts of interest, the rule requires a member to ensure that the person conducting the inspection is not an associated person assigned to the location or is not directly or indirectly supervised by, or otherwise reporting to, an associated person assigned to that location.<sup>22</sup> All branch offices and non-branch locations are subject to Rule 3110(c).

Further, Rule 3110.12 (Standards for Reasonable Review) sets out factors that constitute a reasonable review. This provision emphasizes establishing reasonable supervisory procedures and conducting reviews of locations, taking into consideration, among other things, the member's size, organizational structure, scope of business activities, number and location of the member's offices, the nature and complexity of the products and services offered by the member, 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").<sup>23</sup> The provision further states that the procedures established and reviews conducted must provide that the quality of supervision at remote (*i.e.*, geographically dispersed) locations is sufficient to ensure compliance with applicable securities laws and regulations and with FINRA rules, and that members must be especially diligent with respect to a non-branch location where a registered representative engages in securities activities. This provision incorporates guidance FINRA has previously issued about supervising associated persons working in geographically dispersed offices.<sup>24</sup>

In 2004, the SEC staff similarly provided guidance to broker-dealers on supervision principles.<sup>25</sup> At that time, the SEC staff noted that small, geographically scattered offices presented supervisory challenges when they were not subject to on-site supervision. The SEC staff observed that an office's geographic distance from supervisory personnel could make it easier for registered persons and other employees to carry out and conceal violative conduct. This general observation was derived from SEC enforcement cases finding that firms had inadequately supervised their associated persons working in small, geographically distant offices due to the failure of their supervisory mechanisms to detect and prevent misconduct. Citing technology available at the time, the guidance emphasized that an effective supervisory system for geographically dispersed offices uses a combination of on-site and off-site monitoring; it specifically said that "[c]entralized technology to monitor the trading and handling of funds in remote office accounts, as well as the use of personal computers, helps detect

misappropriation of customer funds, selling away, and unauthorized trading, among other things[.]”<sup>26</sup> The guidance supported both routine or “for cause” on-site inspections, and encouraged unannounced inspections either on a random basis or where there are red flags about unusual activity at those offices. Further, SEC staff and FINRA issued joint guidance that included a FINRA interpretation of Rule 3110(c)(1) requiring member firms to conduct on-site inspections of branch offices and unregistered offices (*i.e.*, non-branch locations) and stating that the inspection process is an element of a firm's compliance and reasonable supervision of its offices and locations, and personnel, and a component of a firm's risk management program.<sup>27</sup> In the joint guidance, the SEC and FINRA also articulated that the “inspection provides the firm with the opportunity to validate its surveillance results from branch offices and to gather on-site intelligence that supplements the ongoing management and surveillance of the branch from a business and risk management standpoint.”<sup>28</sup> Since the time these in-person guidelines were expressed, workplace models have changed significantly and developments in technology have enhanced firms' overall and ongoing supervision and monitoring of the activities occurring at branch offices and non-branch locations. In response to these developments, member firms have questioned the historical expectation that firms satisfy the inspection component of Rule 3110(c) in a physical, on-site manner.

#### B. Environmental Changes Support Revision of In-Person Supervisory Conventions Relating to Rule 3110(c)(1)

Over the years, widespread advancements in technology and communications in the financial industry have significantly changed the way in which members and their associated persons conduct their business and communicate, including the practices that formed the original bases for the on-site inspection. For

<sup>20</sup> See Rule 3110(c)(2).

<sup>21</sup> See Rule 3110(c)(2)(A) (providing that the inspection report must include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures for: (1) safeguarding of customer funds and securities; (2) maintaining books and records; (3) supervision of supervisory personnel; (4) transmittals of funds from customers to third party accounts, from customer accounts to outside entities, from customer accounts to locations other than a customer's primary residence, and between customers and registered representatives, including the hand delivery of checks; and (5) changes of customer account information, including address and investment objectives changes, and validation of such changes).

<sup>22</sup> Rule 3110(c)(3) provides a limited exception from this requirement if a firm determines compliance is not possible either because of the firm's size or its business model. Rule 3110.14 (Exception to Persons Prohibited from Conducting Inspections) reflects FINRA's expectation that a firm generally will rely on the exception in instances where the firm has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager. However, these situations are non-exclusive, and a firm may still rely on the exception in other instances where it cannot comply because of its size or business model, provided the firm complies with the documentation requirements under the rule.

<sup>23</sup> Such red flags may include: customer complaints; a large number of elderly customers; a concentration in highly illiquid or risky investments; an unexplained increase or change in the types of investments or trading concentration that a representative is recommending or trading; an unexpected improvement in a representative's production, lifestyle, or wealth; questionable or frequent transfers of cash or securities between customer or third party accounts, or to or from the representative; a representative that serves as a power of attorney, trustee or in a similar capacity for a customer or has discretionary control over a customer's account(s); a representative with disciplinary records; customer investments in one or a few securities or class of securities that is inconsistent with firm policies related to such investments; churning; trading that is inconsistent with customer objectives; numerous trade corrections, extensions, liquidations; or significant switching activity of mutual funds or variable products held for short time periods. See SLB 17, *supra* note 6; see also Notices 98–38 and 99–45.

<sup>24</sup> See, e.g., Notices 98–38 and 99–45.

<sup>25</sup> See SLB 17, *supra* note 6.

<sup>26</sup> See SLB 17, *supra* note 6.

<sup>27</sup> See Notice 11–54 (stating, in part, a “broker-dealer must conduct on-site inspections of each of its office locations; [OSJs] and non-OSJ branches that supervise non-branch locations at least annually, all non-supervising branch offices at least every three years; and non-branch offices periodically.”). See also SLB 17 (stating, in part, that broker-dealers that conduct business through geographically dispersed offices have not adequately discharged their supervisory obligations where there are no on-site routine or “for cause” inspections of those offices), <https://www.sec.gov/interps/legal/mrslb17.htm>.

<sup>28</sup> See Notice 11–54.

example, making and preserving records electronically have increasingly become the norm and the preferred recordkeeping medium rather than paper (e.g., cloud based storage); communications between and among members, their associated persons and customers commonly take place through email, video or online meeting programs (e.g., WebEx, Zoom) that can be monitored electronically by firms;<sup>29</sup> processes for opening customer accounts and placing trades are moving to online platforms; and customer funds and securities are frequently and increasingly transmitted electronically rather than in physical form (e.g., Venmo, Zelle). Relatedly, the challenges in supervising associated persons who work in outlying offices or locations (i.e., “off-site representative”) have been mitigated over the years with the prevalent and effective use of technology. For example, supervisory reviews for outside business activities of registered persons are often conducted through general internet searches, including social media and online public records, and by reviewing electronic communications and customer fund transfers. Similarly, reviews of correspondence, customer funds and securities, and order flows are accomplished primarily through the use of electronic tracking programs or applications.

In addition, the progressive digitization of firm data and the centralization of control functions have converged, with significant advantages for a firm’s supervision of its business, including monitoring of an associated person’s activities and conducting inspections. Today, many firms capture the lifecycle of an associated person’s activities with a firm, as well as a customer’s interactions with the firm, in digital audit trails. Such activities include, for example, information about associated persons and customers obtained at the account opening process; communications between

associated persons and customers or among associated persons; order and trade activity; and money and security movements in customer accounts. As a result, a firm can monitor the activities of its associated persons and customers continuously, on a real-time or near-real time basis, and react promptly to actual or potential exceptions to routine behaviors, rather than depend on a “point-in-time” office inspection visit on a prescribed schedule.

Further, increased digitization has centralized elements of firm compliance and supervisory functions, and these centralized functions have become the front line in supervision and surveillance. Rather than having a firm’s compliance personnel walk around an office or location during an inspection to identify potential problems or to gather on-site intelligence—an approach that relies on chance encounters such as overhearing an associated person making a sales pitch to a customer for a product a firm is not approved to sell or observing an associated person cutting and pasting a customer signature onto a form—digitization now allows a firm to readily “walk around the data,” reducing the member’s dependence on on-site intelligence because most of activities occurring at an office or location are electronically captured. The technology-driven environment has provided firms the opportunity to develop a more holistic view of a firm’s risk management programs, fostering a more efficient and timely response to areas of concern. For example, centralized control functions strengthen supervision by enabling a firm to implement more frequent or ongoing, repeatable, consistent, and highly scalable approaches to analyzing the activities of associated persons across dispersed offices and locations, creating a level of process discipline not previously achievable in the past. These centralized control functions allow a firm to identify potential areas of concern, and implement targeted solutions or preventative measures in a more timely manner. For example, a fraud specialist team may identify a new fraud scenario and then promptly implement a new surveillance pattern to identify red flags for this behavior throughout the firm. A firm may also use in-house or vendor-created technologies to regularly adjust and “right size” its surveillance alerts and patterns. For example, a firm may quickly adjust its email review lexicons to surveil communications relating to any topic or term.

FINRA notes that firms are turning to new and innovative regulatory tools such as artificial intelligence, natural

language processing, and robotics process automation, among others, to strengthen their compliance programs.<sup>30</sup> Over the last few years, firms have questioned the benefits and practicalities of the need to conduct an inspection in an on-site manner for each office and location, particularly in light of these significant technological advances that have not only changed the way in which firms conduct business and communicate, but also enhanced the effectiveness and efficiencies of a firm’s overall and ongoing supervision and monitoring of the activities occurring at their offices and locations.<sup>31</sup>

### C. Impact of the Pandemic on Workplace Arrangements, and Diversity, Equity and Inclusion

The COVID–19 pandemic, identified in early 2020,<sup>32</sup> has had a profound and lasting impact on workplace arrangements, and brought focus to the integrity of firms’ supervisory systems in a more dispersed work environment. The pandemic accelerated the use of a wide variety of compliance and workplace technology as many government and private employers, including member firms, were driven to adopt a broad remote work environment by quickly moving their employees out of their usual office setting to an alternative worksite such as a private residence. Insights obtained from member firms and other industry representatives through various pandemic-related initiatives and other industry outreach have led FINRA to carefully consider whether some processes and rules, including the manner in which a firm may satisfy its Rule 3110(c)(1) obligations, should be

<sup>30</sup> See generally FINRA White Paper, Technology Based Innovations for Regulatory Compliance (“RegTech”) in the Securities Industry (September 2018), [https://www.finra.org/sites/default/files/2018\\_RegTech\\_Report.pdf](https://www.finra.org/sites/default/files/2018_RegTech_Report.pdf).

<sup>31</sup> Some firms have indicated, for example, that technology has enhanced real time monitoring of their associated persons by providing the ability for firm compliance personnel to join, on an ad hoc basis, digital or virtual meetings occurring between the firm’s associated persons and customers. Firms have also indicated that technology has allowed them to impose various restrictions or limitations on associated persons, such as the ability to print firm records from remote locations using a firm-issued laptop, and only accepting electronic payments from customers.

<sup>32</sup> See Centers for Disease Control and Prevention (“CDC”), International Classification of Diseases, Tenth Revision, Clinical Modification (ICD–10–CM) (Effective March 18, 2020), <https://www.cdc.gov/nchs/data/icd/Announcement-New-ICD-code-for-coronavirus-3-18-2020.pdf>. See also WHO Director-General’s Opening Remarks at the Media Briefing on COVID–19 (March 11, 2020), <https://www.who.int/director-general/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19--11-march-2020>.

<sup>29</sup> Many customers now expect their primary mode of interaction with their firm to be digital. In a study to learn about investors who, during year 2020, entered into the markets using taxable, non-retirement investment accounts, FINRA found that nearly half (48%) of “new investors,” investors who opened a non-retirement investment account during 2020, indicated that they accessed their account primarily through a mobile app, and three-quarters (75%) of “holdover account owners,” investors who maintained a taxable investment account opened before year 2020, indicated they accessed their account primarily through a website. See generally FINRA Investor Education Foundation & NORC, Consumer Insights: Money & Investing, Investing 2020: New Accounts and the People Who Opened Them at 11 (February 2021), [https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them\\_1\\_0.pdf](https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf).

modernized.<sup>33</sup> Technological improvements and developments in regulatory compliance have provided more tools than before to create more effective and efficient compliance programs. To that end, FINRA believes that regulatory models should evolve to benefit from the availability and use of effective technology tools. The SEC's recent Strategic Plan similarly recognized that "[t]echnology and business models are always changing, and it is important for [the SEC] to evolve in kind[.]" and expressed the overall need to "[u]pdate existing SEC rules and approaches to reflect evolving technologies, business models, and capital markets."<sup>34</sup> With the confluence of advances in compliance technology and the shift to hybrid work environments, FINRA believes that the optimal use of on-site inspections deserves further consideration as part of the overall effort to modernize FINRA rules to reflect evolving technologies and business models.<sup>35</sup> As such, FINRA

<sup>33</sup> See generally FINRA's Key Topic: COVID-19/ Coronavirus (referencing, among other things, Frequency Asked Questions, temporary amendments to FINRA rules, and *Regulatory Notices* such as *Regulatory Notices* 20-08 (March 2020) ("Notice 20-08"), regarding pandemic-related business continuity planning, guidance and regulatory relief to member firms from some requirements, including the temporary suspension of the requirement to maintain updated information on Form U4 (Uniform Application for Securities Industry Registration or Transfer) and submit Form BR (Uniform Branch Office Registration Form) for temporary locations; 20-16 (May 2020) ("Notice 20-16"), describing practices implemented by firms to transition to, and supervise in, remote work environment during the COVID-19 pandemic; 20-42 (December 2020) ("Notice 20-42"), seeking comment on lessons from the pandemic; and 21-44 (December 2021), regarding business continuity planning and lessons from the pandemic, <https://www.finra.org/rules-guidance/key-topics/covid-19>. See also SEC Press Release 2022-112 (June 22, 2022) for the Spring 2022 Regulatory Agenda (quoting SEC Chair Gary Gensler: "When I think about the SEC's agenda, I'm driven by two public policy goals: continuing to drive efficiency in our capital markets and modernizing our rules for today's economy and technologies."), [https://www.sec.gov/news/press-release/2022-112?utm\\_medium=email&utm\\_source=govdelivery](https://www.sec.gov/news/press-release/2022-112?utm_medium=email&utm_source=govdelivery).

<sup>34</sup> See SEC, Strategic Plan for fiscal years 2022 to 2026 (November 23, 2022), [https://www.sec.gov/files/sec\\_strategic\\_plan\\_fy22-fy26.pdf](https://www.sec.gov/files/sec_strategic_plan_fy22-fy26.pdf).

<sup>35</sup> FINRA notes one state regulator has issued a policy statement, acknowledging that "more businesses have adapted practices, hired employees, and instituted other changes to their compliance initiatives which have allowed them to adapt to working from a remote setting." As a result, the state securities commissioner concluded that a "full and thorough Branch Inspection conducted remotely may allow broker-dealers similar opportunity to monitor practices and ensure regulatory compliance when compared with in-person Branch Inspections." Through this policy statement, a broker-dealer registered in the state may satisfy that state's branch office examination requirements through remote inspections by using mediums such as video conference and digital file sharing. See Indiana Secretary of State Securities Division, Statement of Policy Regarding Broker-

believes it is appropriate now to assess possible longer-term rule changes and is, therefore, proposing a voluntary, three-year remote inspections pilot program. This program would provide FINRA with specific, structured data from pilot program participants to evaluate impacts—positive and negative—on inspection findings and to systematically assess the overall impact on firms' supervisory systems, which has not been feasible with information drawn from the pandemic-related office shutdowns. Moreover, the proposed pilot program would maintain effective supervision by firms through the ongoing supervisory obligations under Rule 3110, and the proposed limitations on the firms and locations that would be eligible to participate in the proposed pilot program. FINRA emphasizes that the proposed pilot program is not intended to signal the abandonment of on-site inspections, but to assess the effectiveness and efficiency of additional approaches, subject to specified controls, for firms to meet their inspection obligations under Rule 3110(c)(1) while still preserving the investor protection objectives of the rule.

Firms have also conveyed that the flexibility of hybrid work has made a positive impact in attracting more diverse talent and retaining existing talent. These views are consistent with those expressed by several commenters in response to the Initial Rule Filing.<sup>36</sup> For example, several commenters to the Initial Rule Filing noted the positive impact that proposal was expected to have on workplace flexibility and hiring efforts that would enhance talent recruitment and retention in the financial industry, particularly with respect to diversity and inclusion initiatives.<sup>37</sup> In general, the U.S. workforce has increasingly demanded greater workplace flexibility and the securities industry is subject to the same national pressures as it aims to recruit and retain diverse, talented and qualified employees, especially supervisors essential to a reasonably designed supervisory program.<sup>38</sup>

Dealer Branch Office Examinations in 2023 (January 13, 2023), <https://securities.sos.in.gov/sop-bd-branch-exams-2023>.

<sup>36</sup> See Exhibit 2c.

<sup>37</sup> See Exhibit 2c.

<sup>38</sup> See, e.g., McKinsey & Company, Americans are embracing flexible work—and they want more of it (June 23, 2022) (highlighting survey results that 58 percent of U.S. workers, an estimated 92 million people, shared that they can work remotely at least part of the time, and that when employees are given the option to work remotely, 87 percent of employees chose to do so), <https://www.mckinsey.com/industries/real-estate/our->

Notably, the SEC has also indicated that it needed to "harness the benefits of telework as highlighted during the pandemic[.]"<sup>39</sup>

#### (II) FINRA's Observations of Evolving Inspection Practices

Over the last decade, FINRA has observed that the widespread advances in technology in the financial industry, including the progressive digitization of data and the centralization of control functions, have given firms the greater ability to continuously monitor for, identify and investigate atypical behaviors or patterns. With this evolution, the importance of on-site inspections as a primary means to identify non-compliant conduct at all offices and locations has seemingly diminished. Inspection practices that previously depended on an on-site presence at an office or location included, for example, reviewing paper-based books and records (e.g., logs or blotters reflecting transmittals of funds and securities, and paperwork related to new customer accounts); testing the implementation of controls at the office or location relating to the security of checks and stock certificates, the security of an office or location itself (e.g., secured file cabinets containing paper-based books and records); reviewing how supervisors perform their functions such as ensuring that an associated person's uniform form filings were current and accurate; and looking for physical signs of an associated person's outside business activities that were unreported to the firm or a lifestyle that did not align with the associated person's compensation or production levels.

As firms are working in a progressively more digitized environment and operating under a system of controls that has become more centralized, FINRA has observed that in general, much of the work traditionally associated with an on-site inspection takes place before the on-site visit. For example, efforts to investigate potential undisclosed outside business activities or evidence of a registered person's lifestyle that may not be commensurate with the person's revenue production at the firm are accomplished through general internet searches of social media and public records; and irregular customer account activity, trading activity, and written communications are reviewed through the firm's electronic systems. The pandemic has revealed the pragmatism of satisfying

*insights/americans-are-embracing-flexible-work-and-they-want-more-of-it/#/*.

<sup>39</sup> See note 34, *supra*.

Rule 3110(c)(1) through an on-site process in a technological environment that is vastly different from the environment in which the office review requirement was expanded in the 1980s. In engagement with industry representatives, particularly in recent years, some firms have shared with FINRA that the variance between their rates of inspection findings through an on-site process and findings through a remote process were not material. These firm observations align with the observations some commenters conveyed in response to the Initial Rule Filing.<sup>40</sup> Moreover, FINRA's experience examining firms' remote inspection programs also aligns with these observations.

In 2022, FINRA examined several firms, including those that operate under an independent contractor business model and others with branch office networks, to test their compliance with Rule 3110.17, the temporary provision that provides firms the option, subject to the specified requirements under that supplementary material, to complete their calendar year inspection obligations remotely without an on-site visit to the office or location.<sup>41</sup> The targeted examinations assessed firms' implementation of their remote inspection processes and the effectiveness of their supervisory systems. FINRA found that, in general, these systems were effective in supporting remote branch office inspections. Of the examinations completed for Rule 3110.17 compliance, approximately 43% resulted in no findings and 21% identified findings that were operational in nature and did not raise concerns of customer harm, while 36% of the examinations remain ongoing. In addition to engaging in ongoing surveillance of activities, FINRA observed that firms were using, among other inspection tools, "pre-audit" questionnaires to assess the risk level of a branch office and determine the frequency of inspections (remote or on-site) on an announced or unannounced basis. In addition, FINRA observed firms making broad use of technology to supervise the activities of their associated persons remotely to: identify undisclosed private securities transactions and outside business activities; identify problematic electronic communications; surveil trades and movements of customer assets; conduct interviews with

supervisors and other associated persons assigned to the office or location; take and record online office tours; and review associated persons' computers in real-time using tools such as remote desktop software. FINRA's overall examination findings in recent years across all firm examinations conducted during the period in which firms were conducting fully remote inspections or operating in a fully remote or hybrid work environment, have remained within the bounds of general norms.<sup>42</sup>

### (III) The Emergence of Remote Inspections as a New Approach To Evaluate Under Rule 3110(c)(1)

#### A. The 2017 Proposal To Allow Remote Inspections and the Impact From the Pandemic

Even prior to the pandemic, in 2017, FINRA considered a proposal to give firms the option of satisfying the inspection requirement remotely for "qualifying offices" that met specified criteria.<sup>43</sup> However, the pandemic significantly changed the industry's standard business operations, forcing member firms to adapt to a full remote work environment and implement remote supervisory practices.<sup>44</sup> Consequently, FINRA deferred the 2017 Proposal in light of the pressing need to address significant operational disruptions to the securities industry, regulators, impacted member firms, investors and other stakeholders. During this exigent period, FINRA responded to numerous issues and questions that urgently arose.<sup>45</sup> Following up on these actions, FINRA published *Notice 20–42* to gain a broader understanding of member firm experiences during the pandemic. This notice sought feedback from firms about their experiences in a range of areas, including how member firms' operations and business models changed during the public health crisis and how they might further evolve as the pandemic persisted. Other initiatives included sharing general practices of firms in transitioning and

supervising in the remote work environment, and providing temporary relief to member firms from specified FINRA rules and requirements. In particular, to give firms an opportunity to better manage their operational challenges and redirect resources attendant to fulfilling their inspection obligations, FINRA provided temporary relief to member firms pertaining to Rule 3110(c).<sup>46</sup>

#### B. Temporary Amendments to the Inspection Requirement Under Rule 3110(c)

The ensuring pandemic-related operational changes made it impracticable for member firms to conduct the on-site inspection component of Rule 3110(c) at most offices and locations because of limitations on travel to geographically dispersed OSJs, branch offices, and non-branch locations. In response to the logistical challenges, FINRA extended the time by which member firms were required to complete their calendar year 2020 inspection obligations under Rule 3110(c) to March 31, 2021 with the expectation that the extension did not relieve firms from the on-site portion of the inspections of their offices and locations.<sup>47</sup> However, health and safety concerns remained unabated and with many restrictive measures still in place as calendar year 2020 was ending, FINRA adopted Rule 3110.17 to provide member firms the option, subject to specified requirements under the supplementary material, to complete remotely their calendar year inspection obligations without an on-site visit to the office or location.<sup>48</sup> This relief was repeatedly extended and currently, Rule 3110.17 will automatically sunset on December 31, 2023.<sup>49</sup>

Through comments to the 2017 Proposal, *Notice 20–42*, the various temporary amendments to Rule 3110, and other engagement with industry representatives, firms have highlighted

<sup>40</sup> See Rules 3110.16 and 3110.17.

<sup>41</sup> See Securities Exchange Act Release No. 89188 (June 30, 2020), 85 FR 40713 (July 7, 2020) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-019).

<sup>42</sup> See Securities Exchange Act Release No. 90454 (November 18, 2020), 85 FR 75097 (November 24, 2020) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-040).

<sup>43</sup> See Securities Exchange Act Release No. 93002 (September 15, 2021), 86 FR 52508 (September 21, 2021) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2021-023); Securities Exchange Act Release No. 94018 (January 20, 2022), 87 FR 4072 (January 26, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2022-001); and Securities Exchange Act Release No. 96241 (November 4, 2022), 87 FR 67969 (November 10, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2022-030).

<sup>42</sup> FINRA notes that examination findings that were attributable to complying with a new regulation adopted by the SEC, for example, are separate from this general view.

<sup>43</sup> See *Regulatory Notice 17–38* (November 2017) ("2017 Proposal"). FINRA requested comment on a proposed amendment to Rule 3110 to allow remote inspections of "qualifying offices" that met specified criteria, in lieu of on-site inspections of such offices and locations. In general, many of the comment letters FINRA received expressed support for the underlying concept of remote inspections and offered recommendations on specific criteria to broaden the potential population of qualifying offices.

<sup>44</sup> See generally *Notice 20–16*.

<sup>45</sup> See note 33, *supra*.

<sup>40</sup> See Exhibit 2c.

<sup>41</sup> See Securities Exchange Act Release No. 96241 (November 4, 2022), 87 FR 67969 (November 10, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2022-030). See also Item I.A.1.(III)B. for further discussion.

that technological advances, as described above, have allowed a large portion of the inspection work to be conducted electronically, prior to any on-site visit to the office and location, and that in general, inspecting offices and locations in accordance with Rule 3110(c)(1) through a compulsory on-site process is not an efficient and effective use of limited firm resources.<sup>50</sup>

Rule 3110.17 was adopted in the midst of the pandemic, when many offices and locations were forced to close to allow employees to carry on with their responsibilities from alternative worksites. This relief has been extended as pandemic concerns continued.<sup>51</sup> FINRA recognizes that the pandemic has changed the conventional thinking on where work is conducted and this shift in the workforce landscape will unlikely revert to the model that existed pre-pandemic.

#### C. The 2022 Remote Inspections Pilot Program Rule Filing (File No. SR-FINRA-2022-021)

Based on the foregoing, in July 2022, FINRA filed the Initial Rule Filing to amend Rule 3110 to adopt proposed Rule 3110.18 to establish a voluntary, three-year remote inspection pilot program, under terms based largely on Rule 3110.17, but with significant safeguards that would have allowed FINRA the opportunity to collect specified data from pilot program participants to evaluate their experiences and inspection findings in a uniform, comparable manner in the context of then emerging hybrid work model. The SEC twice published the Initial Rule Filing for public comment, which elicited responses from many

<sup>50</sup> In response to FINRA's proposed rule changes associated with Rule 3110.17, one commenter made similar points about the physical, on-site piece of the inspection process. This commenter stated that pre-pandemic, an on-site inspection of a branch office typically consisted of reviewing the lobby area of the office, the back office (to review safe contents, sales literature, daily operations logs containing account applications), signage, and the physical security of the office. See Letter from Carrie L. Chelko, Chief Compliance Officer, Fidelity Brokerage Services LLC ("Fidelity Brokerage") & Norman L. Ashkenas, Chief Compliance Officer, National Financial Services LLC ("NFS") and Fidelity Distributors Company LLC ("Fidelity Distributors"), to Vanessa Countryman, Secretary, SEC, dated July 28, 2020, in response to File No. SR-FINRA-2020-019, <https://www.sec.gov/comments/sr-finra-2020-019/srfinra2020019-7488701-221389.pdf>, and Letter from Gail Merken, Chief Compliance Officer, Fidelity Brokerage, Janet Dyer, Chief Compliance Officer, NFS & John McGinty, Chief Compliance Officer, Fidelity Distributors, to Vanessa Countryman, Secretary, SEC, dated February 16, 2022, in response to File No. SR-FINRA-2022-001, <https://www.sec.gov/comments/sr-finra-2022-001/srfinra2022001-20116307-267950.pdf>.

<sup>51</sup> See note 49, *supra*.

individuals, broker-dealers, law schools, and trade organizations and other associations, including the Securities Industry and Financial Markets Association, the North American Securities Administrators Association, Inc. ("NASAA") and the Public Investors Advocate Bar Association ("PIABA").<sup>52</sup> The SEC received over 30 comment letters during the course of the two comment periods.<sup>53</sup> Most of the comment letters expressed support for the overall objectives of the proposal, and many commenters viewed the proposal as a step towards FINRA rule modernization, and having a positive impact on diversity and inclusion initiatives.<sup>54</sup> However, four commenters, which included NASAA and PIABA, raised concerns with the Initial Rule Filing.<sup>55</sup> NASAA and PIABA each submitted two comment letters expressing opposition to the Initial Rule Filing.<sup>56</sup> NASAA and PIABA asserted generally that the proposal would adversely impact investor protection due to, among other concerns: the adequacy and scope of the proposed pilot program's controls—the exclusions and conditions—to address higher-risk conduct; the identification of technologies firms would use to conduct their inspections remotely; the fundamental change to the approach of supervision; monitoring for pilot program compliance; and the lack of data to fully support the effectiveness of remote inspections.<sup>57</sup>

FINRA submitted a letter responding to comments<sup>58</sup> and filed the Amended Rule Filing in December 2022.<sup>59</sup> The Amended Rule Filing proposed to: (1) add specific risk criteria that a member must consider in making its risk-based evaluation of an office or location; (2) expand the list of exclusions that would make a member ineligible to participate in the proposed pilot program; (3) expand the list of exclusions that would make a specific office or location of a member ineligible for a remote inspection; (4) add express conditions that a member must satisfy to be eligible to conduct remote inspections of any of its offices or locations; (5) add express conditions that a specific office or location of a member must satisfy to be eligible for a remote inspection; and (6) add a new provision to allow FINRA to

<sup>52</sup> See Submitted Comments to File No. SR-FINRA-2022-021, <https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021.htm>.

<sup>53</sup> See note 52, *supra*.

<sup>54</sup> See Exhibit 2c.

<sup>55</sup> See Exhibit 2c.

<sup>56</sup> See note 52, *supra*.

<sup>57</sup> See Exhibit 2c.

<sup>58</sup> See Exhibit 2c.

<sup>59</sup> See Exhibit 2b.

make a determination in the public interest and for the protection of investors that a member is no longer eligible to participate in the proposed pilot program for failing to comply with the requirements of proposed Rule 3110.18. The SEC subsequently published the Amended Rule Filing for public comment,<sup>60</sup> and during the third comment period, the SEC received four more comment letters, including a third letter from NASAA, stating that in general, while the Amended Rule Filing was an improvement to the proposed pilot program, it still needed more guardrails with respect to the risk assessment; written supervisory procedures; the firm level condition relating to surveillance and technology tools; the data and information collection requirement; and FINRA's determination of ineligibility for pilot participation.<sup>61</sup> On April 11, 2023, FINRA withdrew File No. SR-FINRA-2022-021 from the SEC to consider whether more guardrails and clarifications to the filing would be appropriate in response to concerns raised by commenters.<sup>62</sup>

#### (IV) Proposed Voluntary, Three-Year Pilot Program for Remote Inspections

Proposed Rule 3110.18, which sets forth the terms of the proposed pilot program, would build largely on the terms of Rule 3110.17 and retain the key changes as proposed in the 2022 Remote Inspections Pilot Program Rule Filing, including the areas pertaining to the risk assessment, written supervisory procedures, the firm level condition relating to surveillance and technology tools, and FINRA's determination of ineligibility for pilot participation.<sup>63</sup> As detailed below, the proposed rule change would clarify proposed Rule 3110.18 in the areas pertaining to: (1) the frequency of FINRA's data and information collection from pilot program participants, and the type of "findings" that would be part of the collection; and (2) the location level ineligibility criterion for market making and trading activities.

FINRA anticipates that the proposed pilot program will provide broader systemized information to supplement

<sup>60</sup> See Securities Exchange Act Release No. 96520 (December 16, 2022), 87 FR 78737 (December 22, 2022) (Notice of Filing of Partial Amendment No. 1 to File No. SR-FINRA-2022-021).

<sup>61</sup> See Letter from Andrew Hartnett, President, NASAA, to Sherry R. Haywood, Assistant Secretary, SEC, dated January 12, 2023 ("NASAA III"), <https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021-20154758-323090.pdf>.

<sup>62</sup> See Exhibit 2d.

<sup>63</sup> FINRA is also proposing technical changes that would include, among others, reorganizing the presentation of the proposed rule.

the information obtained through the FINRA examination process in an environment where offices and locations were closed. The information firms would be required to produce as a pilot program participant will help FINRA more accurately assess the overall impact and effectiveness of remote inspections.

FINRA is wholly dedicated to ensuring effective firm supervision as a bulwark against misconduct or misadventure that could harm investors. To this end, FINRA has been in the forefront of developing strong supervision standards for member firms. As FINRA emphasized in the proposed rule change to adopt Rule 3110.17, the responsibility of firms to supervise their associated persons on a day-to-day basis is a critical component of broker-dealer regulation.<sup>64</sup> FINRA remains committed to ensuring that firms maintain a strong, effective supervisory system, of which the inspection requirement in Rule 3110(c) is a component. Moreover, this inspection requirement is just one facet of a reasonably designed supervisory system; the inspection process is one of several critical components of the broad supervisory process required of member firms to effectively oversee all of their associated persons, regardless of location, compensation or employment arrangement, or registration status. FINRA believes at this time that the proposed pilot program is consistent with a firm's core responsibility, as set forth in Rule 3110, to 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. Thus, FINRA believes that the remote inspections pilot program's proposed controls and safeguards achieve a responsible balance preserving the investor protection objectives of the rule, while allowing FINRA and the industry to gather data to further evaluate the appropriate contours of the remote inspection construct. FINRA of course welcomes the insights of commenters as FINRA strives to further articulate an effective firm supervisory process.

#### A. Scope (Proposed Rule 3110.18(a))

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(a) would apply to the required inspections of OSJs, branch offices, and non-branch locations under the applicable provisions under Rule 3110(c)(1) for a pilot period of three years starting on

the effective date, and expiring on a date that is three years after the effective date. If the proposed pilot program is not extended or Rule 3110.18, as may be amended, is not approved as permanent by the SEC, the proposed supplementary material would automatically sunset on a date that is three years after the effective date. In addition, proposed Rule 3110.18(a) would expressly state that members would not be able to participate in the proposed pilot program after it expires.

#### B. Risk Assessment (Proposed Rule 3110.18(b))

As described above, Rule 3110(c)(1) provides that an inspection of an office or location must occur on a designated frequency, and the periodicity of the required inspection varies depending on the classification of the location as an OSJ, branch office or non-branch location. Subject to the proposed provisions relating to written supervisory procedures, and the firm and location level requirements as described below, proposed Rule 3110.18(b)(1) would provide that a member firm may elect to conduct the applicable inspection of an office or location during the pilot period remotely, without necessarily an on-site visit for the office or location, when the member reasonably determines that the purposes of the rule can be accomplished by conducting such required inspection remotely.<sup>65</sup> To address the concerns raised by commenters to the Initial Rule Filing that a firm might not appropriately consider certain higher risk criteria in conducting its risk assessment, the Amended Rule Filing added a non-exhaustive list of factors that a firm must consider and document. FINRA is proposing to retain, without substantive change, those terms under proposed Rule 3110.18(b).

#### 1. Standards for Reasonable Review (Proposed Rule 3110.18(b)(1))

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(b)(1) would provide that prior to electing a remote inspection for an office or location, rather than an on-site inspection, the firm must develop a reasonable risk-based approach to using remote inspections and conduct and document a risk assessment for that office or location. The assessment must document the factors considered,

<sup>65</sup> As described further below, a member firm that elects to participate in the proposed pilot program would be subject to the requirements of proposed Rule 3110.18 for a Pilot Year. See proposed Rule 3110.18(i).

including the factors set forth in Rule 3110.12, and must take into account any higher risk activities that take place or higher risk associated persons that are assigned to that location. FINRA expects that higher risk factors at a particular location would cause a firm to conduct on-site inspections of such location. Further, under the proposed supplementary material, a member that is not eligible to conduct remote inspections under paragraphs (f) or (g) under proposed Rule 3110.18, pertaining to firm level and location level requirements, respectively, must conduct an on-site inspection of that office or location on the required cycle. Finally, notwithstanding the pilot program, a member would remain subject to the other requirements and limitations of Rule 3110(c).<sup>66</sup>

#### 2. Other Factors To Consider for the Risk Assessment (Proposed Rule 3110.18(b)(2))

Consistent with the Amended Rule Filing, FINRA is proposing to set forth a non-exhaustive list of factors that a firm must consider and document as part of the risk assessment. Proposed Rule 3110.18(b)(2) would provide that in addition to the requirements under proposed Rule 3110.18(b)(1), a member would be required to consider other factors in making its risk assessment for remotely inspecting an office or location. These factors would include, among others: (1) the volume and nature of customer complaints; (2) the volume and nature of outside business activities, particularly investment-related; (3) the volume and complexity of products offered; (4) the nature of the customer base, including vulnerable adult investors; (5) whether associated persons are subject to heightened supervision; (6) failures by associated persons to comply with the member's written supervisory procedures; and (7) any recordkeeping violations. In addition, proposed Rule 3110.18(b)(2) would provide that, consistent with Rule 3110.12, members should conduct on-site inspections or make more frequent use of unannounced, on-site inspections for high-risk offices or locations or where there are indicators of irregularities or misconduct (*i.e.*, "red flags").

In response to the Amended Rule Filing, NASAA recommended that in the absence of an affirmative on-site inspection requirement, a firm should be required to document its reasons for not conducting an on-site inspection of an office or location, particularly if high

<sup>66</sup> See notes 21 and 22, *supra*, and accompanying text.

<sup>64</sup> See note 48, *supra*.



risk factors or red flags are identified, or the office or location is a private residence.<sup>67</sup> FINRA believes that Rule 3110.18(b), as proposed herein, reflects NASAA's insight. As noted previously, FINRA emphasizes that the inspection requirement is but one part of a firm's overall supervisory system, and that the inspection, whether done remotely or on-site under the proposed pilot program, would be held to the existing standards of review under Rule 3110.12. Those standards provide, in part, that based on the factors set forth under that supplementary material, members "may need to provide for more frequent review of certain locations." FINRA notes that proposed Rule 3110.18(b) would continue to account for the existing standards for reasonable review under Rule 3110.12 and retain the requirement for a firm, before electing a remote inspection for an office or location, to develop a reasonable risk-based approach to using remote inspections for its offices or locations, and conduct and document a risk assessment. In conducting the assessment, a firm must document the factors considered, including the factors set forth in Rule 3110.12, and must take into account any higher risk activities that take place or higher risk associated persons that are assigned to that office or location, irrespective of whether such office or location is a private residence. FINRA expects a firm to carefully consider the proposed factors listed above and Rule 3110.12 for the risk assessment. The outcome of such assessment may raise red flags that should prompt a firm to consider, among other things, more frequent inspections of an office or location—be they remote or on-site—than the schedule set forth under Rule 3110(c)(1) (on an announced or unannounced basis). Further, FINRA notes that Rule 3130 (Annual Certification of Compliance and Supervisory Processes) requires member firms to have processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, Municipal Securities Rulemaking Board rules, and federal securities laws and regulations. FINRA expects firms to consider proposed Rule 3110.18 as part of their annual certification process under Rule 3130.

C. Written Supervisory Procedures for Remote Inspections (Proposed Rule 3110.18(c))

As part of an effective supervisory system tailored specifically to the member firm's business and the activities of all its associated persons, a member must establish and maintain written procedures.<sup>68</sup> Paragraph (1) (General Requirements) under Rule 3110(b) (Written Procedures) provides that a member must establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.

Currently, Rule 3110.17(b) expressly provides that consistent with a member's obligation under Rule 3110(b)(1), a member that elects to conduct each of its inspections in the specified calendar years remotely must amend or supplement its written supervisory procedures to provide for remote inspections that are reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations, and with applicable FINRA rules. In addition, under Rule 3110.17(b), reasonably designed procedures for conducting remote inspection of offices or locations should include, among other things, a description of the methodology, including technologies permitted by the member, that may be used to conduct remote inspections. Further, such procedures should include the use of other risk-based systems employed generally by the member firm to identify and prioritize for review those areas that pose the greatest risk of potential violations of applicable securities laws and regulations, and of applicable FINRA rules.<sup>69</sup> To underscore the importance of Rule 3110(b)(1) in the context of the proposed pilot program, FINRA proposed in the 2022 Remote Inspection Pilot Program Rule Filing to add to the elements currently described under Rule 3110.17(b) an express

provision that the firm must adopt written supervisory procedures regarding remote inspections that are reasonably designed to detect and prevent violations of and achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. In addition, a firm's written supervisory procedures should also include the factors considered in the risk assessment made for each applicable office or location pursuant to proposed Rule 3110.18(b).

In response to this proposed provision, NASAA stated that a firm's written supervisory procedures should require more prescriptive details such as specifying the technologies a firm would be using "for what purposes[.]" and providing evidence of firm personnel's accessibility to and proficiency with those technologies; describing the circumstances under which a firm would conduct an on-site inspection in the "ordinary course" and as a result of risk indicators and red flags; indicating "whether the firm [intended] to conduct unannounced inspections, how the firm intend[ed] to do so remotely, and whether certain factors might influence the firm's decision to do so in particular [circumstances];" and describing "how [a] firm will use its remote inspection procedures to control for the possibility of active deception."<sup>70</sup>

After considering the specific details recommended by NASAA, FINRA is proposing to largely retain the terms as proposed in the 2022 Remote Inspections Pilot Program Rule Filing as consistent with the tenor of other provisions of Rule 3110. Proposed Rule 3110.18(c) would provide that consistent with a member's Rule 3110(b) obligations, a member that elects to participate in the proposed remote inspection pilot program must adopt written supervisory procedures regarding remote inspections that are reasonably designed to detect and prevent violations of and achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. Further, under the proposed provision, reasonably designed procedures for conducting remote inspections of offices or locations must address, among other things: (1) the methodology, including technology, that may be used to conduct remote inspections; (2) the factors considered in the risk assessment made for each applicable office or location pursuant to proposed Rule 3110.18(b); (3) the procedures specified in paragraphs (h)(1)(G) and (h)(4) under

<sup>68</sup> See Rule 3110(a)(1); see generally Notice 99–45 and Regulatory Notice 18–15 (April 2018).

<sup>69</sup> Offices or locations that may present a higher risk profile would include, for example, those that have associated persons engaging in activities that involve handling customer funds or securities, maintaining books and records as described under applicable federal securities laws and FINRA rules, order execution as principal or other activities that may be more susceptible to higher risks of operational or sales practice wrongdoing, or have associated persons assigned to an office or location who may be subject to additional or heightened supervisory procedures.

<sup>70</sup> See NASAA III.

<sup>67</sup> See NASAA III.

proposed Rule 3110.18.<sup>71</sup> and (4) the use of other risk-based systems employed generally by the member firm to identify and prioritize for review those areas that pose the greatest risk of potential violations of applicable securities laws and regulations, and of applicable FINRA rules.

While the details identified by NASAA may be useful elements for firms to consider in devising reasonably designed procedures, FINRA believes that proposed Rule 3110.18(c), read in conjunction with proposed Rule 3110.18(d), as described below, would provide the appropriate level of direction for firms with respect to technology, the areas that written policies and procedures must address, and the use of other risk-based systems while also staying aligned with the principles underlying Rule 3110. FINRA expects firms to take into account the factors affecting their systems and businesses in crafting reasonably designed policies and procedures to achieve the purposes of the rule.

#### D. Effective Supervisory System (Proposed Rule 3110.18(d))

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, FINRA is proposing to retain the terms of Rule 3110.17(c), without substantive change, in proposed Rule 3110.18(d). Similar to Rule 3110.17(c), proposed Rule 3110.18(d) would expressly reiterate the principle that the requirement to conduct inspections of offices and locations is one part of the member's overall ongoing obligation to have an effective supervisory system, and therefore a member must maintain its ongoing review of the activities and functions occurring at all offices and locations whether or not the member conducts inspections remotely. In addition, proposed Rule 3110.18(d) would provide that a member's remote inspection of an office or location would be held to the same standards for review applicable to on-site inspections as set forth under Rule 3110.12.<sup>72</sup> Further, proposed Rule 3110.18(d) would provide that where a member's remote inspection of an office or location identifies any indicators of irregularities or misconduct (*i.e.*, "red flags"), the member may need to impose additional supervisory procedures for that office or

location, or may need to provide for more frequent monitoring or oversight of that office or location, or both, including potentially a subsequent physical, on-site visit on an announced or unannounced basis.

#### E. Documentation Requirement (Proposed Rule 3110.18(e))

In general, Rule 3110(c)(2) imposes various documentation requirements for inspections, including maintaining a written record of the date upon which each inspection is conducted. Currently, Rule 3110.17(d) requires supplemental documentation by a member that avails itself of the remote inspection option. The member must maintain and preserve a centralized record for each of calendar years specified in the supplementary material that separately identifies: (1) all offices or locations that had inspections that were conducted remotely; and (2) any offices or locations that the member determined to impose additional supervisory procedures or more frequent monitoring, as provided in Rule 3110.17(c). A member's documentation of the results of a remote inspection for an office or location must identify any additional supervisory procedures or more frequent monitoring for that office or location that were imposed as a result of the remote inspection.

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, FINRA is proposing to incorporate, without substantive change, the terms of Rule 3110.17(d) in proposed Rule 3110.18(e), while making two clarifying changes. One change would be to reference that the centralized record must be for each of the "pilot years" (as defined in proposed Rule 3110.18(l)), and the other change would be to clarify that a member's documentation of the results of a remote inspection for an office or location must identify any additional supervisory procedures or more frequent monitoring for that office or location that were imposed as a result of the remote inspection, including whether an on-site inspection was conducted at such office.

#### F. Firm Level Requirements (Proposed Rule 3110.18(f))

In the Initial Rule Filing, FINRA proposed to exclude some member firms from participating in the proposed pilot program. The categories of ineligibility were events or activities of a member firm that FINRA explained were more likely to raise investor protection concerns based on the firm's record of specified regulatory or disciplinary events. Some commenters to the Initial Rule Filing expressed general concerns

relating to the adequacy and scope of those proposed controls—the exclusions and conditions—to address higher risk conduct.<sup>73</sup> In response to those concerns, the Amended Rule Filing proposed expanding the list of controls. The proposed rule change would retain, without substantive change, the criteria as set forth in the Amended Rule Filing.

#### 1. Firm Level Ineligibility Criteria (Proposed Rule 3110.18(f)(1))

Under proposed Rule 3110.18(f)(1), a member firm would be ineligible to conduct remote inspections of any of its offices if any time during the pilot period, the member: (1) is or becomes designated as a Restricted Firm under Rule 4111<sup>74</sup> (proposed Rule 3110.18(f)(1)(A)); (2) is or becomes designated as a Taping Firm under Rule 3170<sup>75</sup> (proposed Rule 3110.18(f)(1)(B)); (3) receives a notice from FINRA pursuant to Rule 9557 regarding compliance with Rule 4110 (Capital Compliance), Rule 4120 (Regulatory Notification and Business Curtailment) or Rule 4130 (Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties) (proposed Rule 3110.18(f)(1)(C)); (4) is or becomes suspended from membership by FINRA (proposed Rule 3110.18(f)(1)(D)); (5) based on the date in the Central Registration Depository ("CRD<sup>®</sup>")<sup>76</sup> had its FINRA membership become effective within the prior 12 months (proposed Rule 3110.18(f)(1)(E)); or (6) is or has been found within the past three years by the SEC or FINRA to have violated

<sup>73</sup> See Exhibit 2c.

<sup>74</sup> In general, Rule 4111 (Restricted Firm Obligations) requires member firms that are identified as "Restricted Firms" to deposit cash or qualified securities in a segregated, restricted account; adhere to specified conditions or restrictions; or comply with a combination of such obligations. See generally *Regulatory Notice* 21–34 (September 2021) (announcing FINRA's adoption of rules to address firms with a significant history of misconduct).

<sup>75</sup> In general, Rule 3170 (Tape Recording of Registered Persons by Certain Firms) requires a member firm to establish, enforce and maintain special written procedures supervising the telemarketing activities of all of its registered persons, including the tape recording of conversations, if the firm has hired more than a specified percentage of registered persons from firms that meet FINRA Rule 3170's definition of "disciplined firm." See generally *Regulatory Notice* 14–10 (March 2014) (announcing FINRA's adoption of consolidated rules governing supervision).

<sup>76</sup> CRD is the central licensing and registration system that FINRA operates for the benefit of FINRA, the SEC, other SROs, state securities regulators and broker-dealer firms. The information maintained in the CRD system is reported by registered broker-dealer firms, associated persons and regulatory authorities in response to questions on specified uniform registration forms. See generally Rule 8312 (FINRA BrokerCheck Disclosure).

<sup>71</sup> The areas specified in proposed Rule 3110.18(h)(1)(G) include the procedures for escalating significant findings, new hires, supervising brokers with a significant history of misconduct, outside business activities and doing business as designations, and the areas specified in proposed Rule 3110.18(h)(4) include data and information collection, and transmission.

<sup>72</sup> See note 23, *supra*, and accompanying text.

Rule 3110(c) (proposed Rule 3110.18(f)(1)(F)).<sup>77</sup>

Rules 4111 and 3170 expressly address firms that pose higher risks, and for that reason, those firms would be ineligible to participate in the proposed pilot program. Further, FINRA believes that a member firm that is experiencing issues complying with its capital requirements or has been suspended from membership by FINRA is more likely to face significant operational challenges that may negatively impact the firm's inspection program. FINRA further believes that a firm that has been a FINRA member for less than 12 months is often still implementing its business plan and may not have sufficient experience to develop a sufficiently robust inspection program. With respect to a firm that is or has been found within the past three years by the SEC or FINRA to have violated Rule 3110(c), FINRA believes such firms have demonstrated challenges in developing or maintaining robust inspection programs. Collectively, FINRA believes that these proposed ineligibility criteria would appropriately limit the potential population of pilot program participants to those firms that may be better positioned to conduct remote inspections.

## 2. Firm Level Conditions (Proposed Rule 3110.18(f)(2))

To further address commenters' concerns pertaining to the adequacy and scope of the proposed controls of the pilot program, the Amended Rule Filing proposed enhancing the controls with respect to books and records, and surveillance and technology tools. In that filing, FINRA explained that those conditions were appropriate to establish reasonable baseline requirements for remote inspections. FINRA reaffirms this view through this proposed rule change by retaining, without substantive change, the conditions set forth in the Amended Rule Filing.

### a. Recordkeeping System (Proposed Rule 3110.18(f)(2)(A))

As part of the requirements in proposed Rule 3110.18(b) to develop a reasonable risk-based approach to using remote inspections, and to conduct and document a risk assessment for each office or location, the member must, under proposed Rule 3110.18(f)(2)(A), have a recordkeeping system to make and keep current, and preserve records required to be made and kept current, and preserved under applicable

securities rules and regulations, FINRA rules, and the member's own written supervisory procedures under Rule 3110. In addition, such records may not be physically or electronically maintained and preserved at the office or location subject to the remote inspection, and the member has prompt access to such records.

### b. Surveillance and Technology Tools (Proposed Rule 3110.18(f)(2)(B))

In response to the Initial Rule Filing, NASAA expressed general concern about the lack of detail on the technology firms use to conduct effective remote surveillance.<sup>78</sup> Many commenters, however, had countered with the view that advances in technology have facilitated remote surveillance, including inspections, with some commenters describing the technology that they leverage to effectively surveil and inspect offices and locations remotely.<sup>79</sup> Examples included the use of laptops connected to the firm's network; smart phones for live video calls; video conferencing technology; electronic notifications of shipments to and from an office or location; and internet searches of social media and public records.<sup>80</sup> To address NASAA's general concerns about surveillance and technology, the Amended Rule Filing provided that as part of the requirement to develop a reasonable risk-based approach to using remote inspections, and the requirement to conduct and document a risk assessment for each office or location, the member must determine that its surveillance and technology tools are appropriate to supervise the types of risks presented by each such office or location, and set forth a description of the types of tools (e.g., electronic surveillance of email, electronic trade blotters, secure network connections). However, in response to the Amended Rule Filing, NASAA, while acknowledging that supervisory requirements are principles-based, suggested that FINRA should revise the proposed provision to establish a mandatory technology floor for participants in the proposed pilot program comprising the tools commenters listed as examples of effective technologies.<sup>81</sup>

As noted above, FINRA is proposing to retain, without substantive change, the condition pertaining to surveillance and technology tools as set forth in the Amended Rule Filing, as consonant

with the principle-based tenor of the rule. Under proposed Rule 3110.18(f)(2)(B), as part of the requirement to develop a reasonable risk-based approach to using remote inspections, and the requirement to conduct and document a risk assessment for each office or location, the member must determine that its surveillance and technology tools are appropriate to supervise the types of risks presented by each such remotely supervised office or location. The proposed provision would provide that these tools may include but are not limited to: (1) firm-wide tools such as electronic recordkeeping systems, electronic surveillance of email and correspondence, electronic trade blotters, regular activity-based sampling reviews, and tools for visual inspections; (2) tools specifically applied to such office or location based on the activities of associated persons, products offered, restrictions on the activity of the office or location (including holding out to customers and handling of customer funds or securities); and (3) system security tools such as secure network connections and effective cybersecurity protocols. FINRA believes that proposed Rule 3110.18(f)(2)(B) appropriately conveys a reasonable baseline requirement for remote inspections. FINRA maintains that it would not be appropriate to identify specific technology-based tools because of the evolving development and ongoing advances in technologies. Moreover, FINRA notes that proposed Rule 3110.18(c) would require a firm to adopt reasonably designed written supervisory procedures that must include, among other things, a description of the methodology, including the technology, that a firm may use to conduct remote inspections.

### G. Location Level Requirements (Proposed Rule 3110.18(g))

In the Initial Rule Filing, FINRA had proposed several criteria that if met would render a member's office or location ineligible for remote inspection. The categories of ineligibility were events or activities of an associated person of the member firm that FINRA had explained were more likely to raise investor protection concerns based on the individual's record of specified regulatory or disciplinary events. Some commenters to the Initial Rule Filing expressed general concerns relating to the discretion provided to firms to make risk assessments as to whether an office or location could undergo a remote

<sup>77</sup> FINRA notes that the term "found" as used in this proposed criterion would carry the same meaning as Rule 4530.03 (Meaning of "Found").

<sup>78</sup> See Exhibit 2c.

<sup>79</sup> See Exhibit 2c.

<sup>80</sup> See Exhibit 2c.

<sup>81</sup> See NASAA III.

inspection.<sup>82</sup> In response to those concerns, FINRA had expanded the list of events or activities that would deem a specific office or location of a member ineligible from participating in the pilot program. The proposed rule change would retain the criteria set forth in the Amended Rule Filing, but with one clarifying adjustment pertaining to an associated person who is a part of a member's trading desk.

#### 1. Location Level Ineligibility Criteria (Proposed Rule 3110.18(g)(1))

Under proposed Rule 3110.18(g)(1), a member firm's office or location would be ineligible for a remote inspection if at any time during the period of the proposed pilot program, an associated person at such office or location is or becomes: (1) subject to a mandatory heightened supervisory plan under the rules of the SEC, FINRA or state regulatory agency (proposed Rule 3110.18(g)(1)(A)); (2) statutorily disqualified, unless such disqualified person has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member and is not subject to a mandatory heightened supervisory plan under proposed Rule 3110.18(g)(1)(A) or otherwise as a condition to approval or permission for such association (proposed Rule 3110.18(g)(1)(B)); (3) subject to Rule 1017(a)(7)<sup>83</sup> as a result of one or more associated persons at such location (proposed Rule 3110.18(g)(1)(C)); (4) one or more associated persons at such location has an event in the prior three years that required a "yes" response to any item in Questions 14A(1)(a) and 2(a), 14B(1)(a) and 2(a), 14C, 14D and 14E on Form U4<sup>84</sup> (proposed Rule 3110.18(g)(1)(D)); (5) one or more associated persons at such office or location is or becomes subject to a disciplinary action taken by the member that is or was reportable under Rule 4530(a)(2) (proposed Rule

3110.18(g)(1)(E));<sup>85</sup> or (6) the office or location handles customer funds or securities (proposed Rule 3110.18(g)(1)(G)).<sup>86</sup> These proposed criteria remain substantively unchanged from the Amended Rule Filing.

In the Amended Rule Filing, FINRA had also proposed a criterion that would make a member firm's office or location ineligible for a remote inspection if one or more associated persons at such office or location was "a part of the member's trading desk (e.g., engaging in market making activities or having authority to enter proprietary trades on behalf of the member or as agent for other parties)[.]"<sup>87</sup> In response to the Amended Rule Filing, one commenter conveyed that the proposed criterion was overly broad, and overstated the risks presented by trade desk personnel.<sup>88</sup> FINRA is proposing to adjust this criterion. As adjusted, under proposed Rule 3110.18(g)(1)(F), a member firm's office or location would be ineligible for a remote inspection if at any time during the period of the proposed pilot program, an associated person at such office or location is engaged in proprietary trading, including the incidental crossing of customer orders, or the direct supervision of such activities.<sup>89</sup>

#### 2. Location Level Conditions (Proposed Rule 3110.18(g)(2))

To further address the concerns about the adequacy and scope of the proposed pilot program's controls, the Amended Rule Filing had proposed enhancing the controls with respect to electronic communications, correspondence and books and records. FINRA is proposing to retain, without substantive change, the conditions set forth in the Amended Rule Filing. Under proposed Rule

3110.18(g)(2), as part of the requirement to develop a reasonable risk-based approach to using remote inspections, and the requirement to conduct and document a risk assessment for each office or location, the member must satisfy the following conditions: (1) electronic communications (e.g., email) are made through the member's electronic system; (2) the associated person's correspondence and communications with the public are subject to the firm's supervision in accordance with Rule 3110; and (3) no books or records of the member required to be made and kept current, and preserved under applicable securities laws and regulations, FINRA rules, and the member's own written supervisory procedures under Rule 3110 are physically or electronically maintained and preserved at such office or location. FINRA believes that proposed Rule 3110.18(g)(2) appropriately conveys a reasonable set of conditions related to communications of associated persons and the creation and preservation of books and records at a specific office or location.

FINRA believes that the proposed location level ineligibility criteria are indicia of increased risk to investors at some office or locations, such that they should not be eligible for remote inspections in accordance with the proposed pilot program.

A member firm, or an office or location subject to one of the categorical restrictions would not be eligible for remote inspections, even if the firm's risk assessment concludes that a remote inspection would be appropriate. A member firm that meets one of these ineligibility criteria would not be able to participate in the proposed pilot program. If a member firm is eligible to participate in the proposed pilot program, but one of its offices or locations meets one of the location level ineligibility criteria, the member would be required to conduct an on-site inspection of that office or location on the required cycle. FINRA believes the proposed list of ineligibility categories is appropriately derived from existing rule-based criteria that are part of processes to identify firms that may pose greater concern (e.g., Rules 4111 and 3170) or associated persons that may pose greater concerns due to the specified activities and nature of disclosures of regulatory or disciplinary events on the uniform registration forms. FINRA believes that these objective categorical restrictions will provide safeguards that will help ensure that firms maintain effective supervisory procedures during the pilot period.

<sup>82</sup> See Exhibits 2b and 2c.

<sup>83</sup> In general, Rule 1017(a)(7) requires a member firm to file a CMA when a natural person seeking to become an owner, control person, principal or registered person of the member firm has, in the prior five years, one or more defined "final criminal matters" or two or more "specified risk events" unless the member firm has submitted a written request to FINRA seeking a materiality consultation for the contemplated activity. Rule 1017(a)(7) applies whether the person is seeking to become an owner, control person, principal or registered person at the person's current member firm or at a new member firm. See generally *Regulatory Notice 21-09* (March 2021) (announcing FINRA's adoption of rules to address brokers with a significant history of misconduct).

<sup>84</sup> Form U4's Questions 14A(1)(a) and 2(a), 14B(1)(a) and 2(a) elicit reporting of criminal convictions, and Questions 14C, 14D, and 14E pertain to regulatory action disclosures.

<sup>85</sup> Paragraph (a)(2) under Rule 4530 (Reporting Requirements) requires a member firm to report when an associated person of the member is the subject of any disciplinary action taken by the member involving suspension, termination, the withholding of compensation or of any other remuneration in excess of \$2,500, the imposition of fines in excess of \$2,500 or is otherwise disciplined in any manner that would have a significant limitation on the individual's activities on a temporary or permanent basis.

<sup>86</sup> In accordance with existing guidance, the meaning and interpretation of the term "handled" that currently appears in Rule 3110(f)(2)(A)(ii) would remain consistent in the proposed pilot program. See also *Notice to Members 06-12* (March 2006).

<sup>87</sup> See Exhibit 2b.

<sup>88</sup> See Letter from Sandip Khosla, General Counsel, Two Sigma Securities, LLC, to Vanessa A. Countryman, Secretary, SEC, dated January 12, 2023, <https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021-20154757-323056.pdf>.

<sup>89</sup> FINRA notes that this proposed criterion would encompass trading activity in any security, whether traded on a national securities exchange or over-the-counter.

## H. Data and Information Collection Requirement (Proposed Rule 3110.18(h))

### 1. Data and Information (Proposed Rule 3118.18(h)(1))

As noted above, Rule 3110.17 was adopted in the midst of the pandemic and operationalized in an environment in which many offices and locations were closed to the public. FINRA believes that the formalized, uniform collection of data is critical to allow FINRA to meaningfully assess the effectiveness of remote inspections to help shape potential permanent amendments to Rule 3110(c) that would optimize an inspection program in the evolving workplace environment. FINRA believes having a pilot program for remote inspections with appropriate conditions, limitations and documentation requirements in an environment that is settling into a hybrid workplace model would provide a clearer picture of the strengths and weaknesses of remote inspections, without compromising investor protection. Proposed Rule 3110.18(h), the terms of which are similar to those set forth in the 2022 Remote Inspections Pilot Program Rule Filing, would impose upon firms a data and information collection requirement as a condition for participating in the pilot program. On a quarterly frequency, participating firms would be required to collect and produce to FINRA, in a manner and format determined by FINRA, data consisting of separate counts for OSJs, supervisory branch offices, non-supervisory branch offices, and non-branch locations, consistent with paragraphs (c)(1)(A), (B) and (C) under Rule 3110, for several categories. These categories include: (1) the total number of inspections—on-site and remote—completed during each calendar quarter;<sup>90</sup> (2) the number of those office or locations in each calendar quarter that were subject to an on-site inspection because of a “finding,” (as described under proposed Rule 3110.18(h)(1) as a discovery made during an inspection that led to a remedial action or was listed on the member’s inspection report);<sup>91</sup> (3) the number of locations for which a remote inspection was conducted in the calendar quarter that identified a finding, the number of findings, and a list of the most significant findings;<sup>92</sup>

<sup>90</sup> See proposed Rule 3110.18(h)(1)(A), (B) and (C).

<sup>91</sup> See proposed Rule 3110.18(h)(1)(D).

<sup>92</sup> See proposed Rule 3110.18(h)(1)(E). A “significant finding” would be one that should prompt the firm to take further action that could include escalation to the appropriate channels at the firm for further review, the result of which may

and (4) the number of locations for which a on-site inspection was conducted in the calendar quarter that identified a finding, the number of findings, a list of the most significant findings.<sup>93</sup> In addition, firms would be required to provide FINRA their written supervisory procedures for remote inspections that account for: (1) escalating significant findings; new hires; supervising brokers with a significant history of misconduct; and outside business activities and “doing business as” (or DBA) designations.<sup>94</sup> Firms would be required to provide FINRA with a copy of these written supervisory procedures alongside the first delivery of the data points described above, and any subsequent amendments to such procedures for remote inspections.<sup>95</sup>

In response to the Amended Rule Filing, NASAA suggested that firms should be required to provide FINRA with “‘all findings’ made during remote inspections, not only the ones the firm subjectively deems ‘most significant’[,]” contending that the discretion given to firms to make this determination would undermine the data and hinder FINRA’s ability to assess trends and developments.<sup>96</sup> FINRA believes that to require firms to provide “all findings” rather than the “significant findings” would yield an overly broad data set where it would be challenging to discern key trends in a meaningful way. Moreover, while Rule 3110(c)(2) specifies the areas that a firm must address in an inspection report, if applicable to the office or location being inspected, the rule does not impose any other content requirements of an inspection report. FINRA believes that pilot program participants, which FINRA would expect to reflect a variety of attributes (e.g., size, business model, organizational structure), should have the agency to assess their significant findings and report them to FINRA in the manner specified under the proposed rule. FINRA maintains that this approach would enhance FINRA’s ability to review a discrete set of data

be enhanced monitoring or surveillance of a particular event or activity through more frequent inspections (remotely or on-site), on an announced or unannounced basis, of the office or location, or other targeted reviews of the root cause of the finding. Examples of some findings that may prompt escalation or further internal review by the appropriate firm personnel include, among other things, the use of unapproved communication mediums, customer complaints, or undisclosed outside business activities or private securities transactions.

<sup>93</sup> See proposed Rule 3110.18(h)(1)(F).

<sup>94</sup> See proposed Rule 3110.18(h)(1)(G)(i) through (iv).

<sup>95</sup> See proposed Rule 3110.18(h)(1)(G).

<sup>96</sup> See NASAA III.

that would focus on key areas of concern to firms, which in turn, would help FINRA assess the effectiveness of remote inspections.

### 2. Additional Data and Information for Pilot Year 1, if Less Than Full Calendar Year (Proposed Rule 3110.18(h)(2)) and for Calendar Year 2019 (Proposed Rule 3110.18(h)(3))

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(h)(2) would address the additional data and information requirements for Pilot Year 1 (as defined under proposed Rule 3110.18(l)), if such year covers a period that is less than a full calendar year. In such case, a member that elects to participate in the proposed pilot program would be required to collect the following data and information and provide such data and information to FINRA (in a manner and format FINRA determines) no later than December 31 of such first Pilot Year. For items (1) through (3) below, a member would be required to provide separate counts for OSJs, supervisory branch offices, non-supervisory branch offices, and non-branch locations consistent with paragraphs (c)(1)(A), (B) and (C) under Rule 3110: (1) the number of locations with an inspection completed during the full calendar year of the first Pilot Year; (2) the number of locations in item (1) that were inspected remotely during the full calendar year of the first Pilot Year; and (3) the number of locations in item (1) that were inspected on-site during the full calendar year of the first Pilot Year. This additional data and information would provide FINRA the ability to capture, in the aggregate, complete inspection counts—total number of Rule 3110(c)(1) inspections (remote and on-site)—for the entire calendar year in addition to the more detailed data and information requirements under proposed Rule 3110.18(h)(1).

In response to the Amended Rule Filing, NASAA recommended that firms be required to provide FINRA with the information specified in the proposed provision relating to data and information collection to cover the most recent 12-month period during which the firm conducted in-person inspections under Rule 3110(c). FINRA agrees with this approach. Thus, in addition to the data and information requirement under paragraphs (h)(1) and (h)(2) to proposed Rule 3110.18, proposed Rule 3110.18(h)(3) would require a pilot program participant to collect and provide to FINRA calendar year 2019 data and information no later than December 31 of Pilot Year 1 (as

defined under proposed Rule 3110.18(l)). For items (1) and (2) below, a member would be required to provide separate counts for OSJs, supervisory branch offices, non-supervisory branch offices, and non-branch locations consistent with paragraphs (c)(1)(A), (B) and (C) under Rule 3110: (1) the number of locations with an inspection completed during calendar year 2019; and (2) the number of locations in item (1) where findings were identified, the number of those findings and a list of the most significant findings. This additional data and information covering calendar year 2019, when firms conducted their inspections solely on-site, would provide FINRA with some baseline data and information about on-site inspections immediately preceding the pandemic.

### 3. Written Policies and Procedures (Proposed Rule 3110.18(h)(4))

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(h)(4) would remind firms of the general requirement to establish, maintain and enforce written policies and procedures that are reasonably designed to comply with the data and information collection, and transmission requirements of the proposed pilot program.

#### I. Election To Participate in Remote Inspections Pilot Program (Proposed Rule 3110.18(i))

Consistent with the 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(i) would set forth the manner in which a firm would notify FINRA of the firm's election to participate in the proposed pilot program and to withdraw from it. The proposed rule would provide that FINRA may, in exceptional cases and where good cause is shown, waive the applicable timeframes described below for the required opt-in or opt-out notices.

Proposed Rule 3110.18(i) would require a firm, at least five calendar days before the beginning of such Pilot Year, to provide FINRA an "opt-in notice" in the manner and format determined by FINRA. By providing such opt-in notice to FINRA, the firm agrees to participate in the proposed pilot program for the duration of such Pilot Year and to comply with the requirements of Rule 3110.18.<sup>97</sup> A firm that provides the opt-in notice for a Pilot Year would be automatically deemed to have elected and agreed to participate in the Remote

Inspections Pilot Program for subsequent Pilot Years (*i.e.*, Pilot Year 2, Pilot Year 3, and Pilot Year 4, if applicable) until the pilot program expires. Further, proposed Rule 3110.18(i) would describe the notice requirement for a firm to withdraw from the proposed pilot program. A firm would be required to provide FINRA with an "opt-out notice" at least five calendar days before the end of the then current Pilot Year.

By way of example, a firm that provides FINRA an opt-in notice on June 26 to join Pilot Year 1 that begins on July 1 would be automatically deemed to continue participating in Pilot Year 2 unless the firm provides FINRA the required opt-out notice no later than December 26 of Pilot Year 1. To continue with this example, a firm that was automatically deemed to participate in Pilot Year 2 and determines in mid-Pilot Year 2 that it does not want to automatically continue into Pilot Year 3 could elect to withdraw from Pilot Year 3 if it provides FINRA an opt-out notice at least five calendar days before the end of Pilot Year 2. However, because Pilot Year 2 is already underway, the firm would be required to complete Pilot Year 2 in accordance with proposed Rule 3110.18.

FINRA believes that this proposed operational aspect of the program would not only establish a cohesive process in which firms and FINRA may manage program participation but also lend some continuity in data and information collection that would support FINRA's assessment and evaluation of the experiences of pilot program participants.

#### J. Failure To Satisfy Conditions (Proposed Rule 3110.18(j))

Consistent with 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(j) would address a situation in which a firm fails to satisfy terms of the proposed pilot program. The proposed paragraph would provide that a firm that fails to satisfy the conditions of Rule 3110.18, including the requirement to timely collect and submit the data and information to FINRA as set forth in proposed Rule 3110.18(h), would be ineligible to participate in the pilot program and must conduct on-site inspections of each office and location on the required cycle in accordance with Rule 3110(c).

#### K. Determination of Ineligibility (Proposed Rule 3110.18(k))

To address commenters' concerns pertaining to monitoring for compliance

with the proposed pilot program, the Amended Rule Filing had proposed a provision to allow FINRA to make a determination in the public interest and for the protection of investors that a member is no longer eligible to participate in the proposed pilot program if the member fails to comply with the requirements of the proposed pilot program. The proposal further provided that FINRA would provide written notice to the member of such determination and such member would no longer be eligible to participate in the proposed pilot program and would be required to conduct on-site inspections of required offices and locations in accordance with Rule 3110(c). In the Amended Rule Filing, FINRA had explained that this authority would both align with FINRA's examination and risk monitoring programs for member firms and registered persons and allow FINRA to more effectively assess higher risk. In response to the Amended Rule Filing, NASAA stated that the proposed provision should be expanded broadly to provide FINRA the ability to make such a determination if it finds that a firm "fail[ed] to comply with the requirements of applicable laws, rules, and regulations related to supervision of associated persons[.]" stating that this broad scope would provide the appropriate level of flexibility "to protect investors from misconduct and lax supervisory practices."<sup>98</sup>

FINRA believes that the proposed provision is sufficiently broad in scope for purposes of the proposed pilot program. FINRA reiterates that the purpose of the proposed three-year pilot program, which is voluntary, is to study the effectiveness of remote inspections in accordance with Rule 3110(c)(1) as part of a reasonably designed supervisory system. Consistent with the Amended Rule Filing, FINRA is proposing to retain, without substantive change, proposed Rule 3110.18(k) under the described terms.

#### L. Definitions (Proposed Rule 3110.18(l))

Consistent with 2022 Remote Inspections Pilot Program Rule Filing, proposed Rule 3110.18(l) would set forth the meanings underlying "Pilot Year" to explain the duration of the proposed pilot program. Under proposed Rule 3110.18(l), a "Pilot Year" would mean the following: (1) Pilot Year 1 would be the period beginning on the effective date of the proposed pilot program and ending on December 31 of the same year; (2) Pilot Year 2 would mean the calendar year period

<sup>97</sup> A firm that participates in a Pilot Year would be committed to complying with the terms of proposed Rule 3110.18 for that Pilot Year.

<sup>98</sup> See NASAA III.

following Pilot Year 1, beginning on January 1 and ending on December 31; and (3) Pilot Year 3 would mean the calendar year period following Pilot Year 2, beginning on January 1 and ending on December 31. Finally, if applicable, where Pilot Year 1 covers a period that is less than a full calendar year, then Pilot Year 4 would mean the period following Pilot Year 3, beginning on January 1 and ending on a date that is three years after the effective date.

**M. Sunset of Rule 3110.17 (Proposed Rule 3110.18(m))**

As noted above, Rule 3110.17 is set to expire on December 31, 2023.<sup>99</sup> FINRA will submit a separate rule filing if, during the pendency of the SEC's determination of whether to approve or disapprove this proposed rule change, FINRA seeks to extend the duration of Rule 3110.17 beyond the current term. Proposed Rule 3110.18 would expressly account for the possibility of overlapping provisions if the proposed pilot program becomes effective while Rule 3110.17 is also in effect. Proposed paragraph (m), which is nearly identical to the provision set forth in the 2022 Remote Inspections Pilot Program Rule Filing, would provide that if Rule 3110.17 has not already expired by its own terms (on December 31, 2023 or as the case may be, on an extended date), it would automatically sunset on the effective date of proposed Rule 3110.18.

Consistent with the principles set forth in prior guidance, FINRA expects members to establish reasonably designed inspection programs. The proposed pilot program for remote inspections does not alter the core obligation of a member firm to 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.<sup>100</sup> As part of the inspection planning process, FINRA expects members to continue with their ongoing supervision, including risk analysis of the activities and functions occurring at all offices or locations. While the option to conduct remote inspections in accordance with proposed Rule 3110.18 provides greater choice in how to effectively supervise some offices or locations, a member must continue to consider the factors described in Rule 3110.12, along with the activities taking place there. This analysis may require the member to conduct a physical, on-site inspection of an office or location. Where there are

indications of problems or red flags at any office or location, FINRA expects members to investigate them as they would for any other office or location subject to Rule 3110(c), which may include an unannounced, on-site inspection of the office or location. FINRA is committed to diligently monitoring the impacts of remote inspections on a firms' overall supervisory systems and reviewing the data over the life of the proposed pilot program to assess how firms apply the flexibility provided by the pilot program while maintaining an effective supervisory program.

**(V) FINRA's Monitoring and Compliance With Proposed Rule 3110.18**

**A. Overview of FINRA's Data-Driven, Risk-Based Regulatory Framework**

FINRA's data-driven regulatory programs are integrated among various FINRA departments, and the data and information FINRA currently collects from its member firms helps provide FINRA with a holistic view of firm risk management. FINRA's Examinations and Risk Monitoring Program, which is a part of FINRA's Member Supervision Department, is a critical component of FINRA's regulatory operations, and one of the many ways in which FINRA oversees the activities of member firms and its associated persons with the goal of detecting, deterring, and addressing activities that may cause investor harm or adversely impact market integrity.<sup>101</sup>

FINRA's Risk Monitoring is organized by the primary business model of member firms<sup>102</sup> and serves as a point of contact for FINRA member firms on a range of topics that may include, among others, financial and business conduct requirements and firm submissions (e.g., FOCUS filings, Rule 4530 filings, other reporting requirements), published guidance, and new FINRA rules. This relationship allows Risk Monitoring to cultivate a thorough understanding of the business activities and operations of each firm they monitor. This knowledge, along with the data FINRA collects serves FINRA by providing ongoing awareness and analysis of member firm activities, including business lines, operations, products, and controls. This proactive monitoring, with Risk Monitoring as the point of contact for member firms,

enables FINRA to implement a risk-based regulatory program that focuses resources and regulator responses on concerning risks. This assessment methodology plays a role in many aspects of FINRA's regulatory programs, including FINRA's Examinations in the preparation of firm examinations. The type of examination may depend upon the firm profile that is created by a number of attributes, including among others, business model, size, the products offered, and disciplinary history of the firm and its registered persons. The areas of review in an examination may also be influenced by the adoption of a new FINRA rule and any accompanying guidance or interpretation.

As described above, the terms of proposed Rule 3110.18 include several rule-based or reportable criteria, or information that is electronically captured that FINRA can readily monitor through Risk Monitoring and Examinations. These criteria relate to Rules 1017(a)(7), 3170, 4111, and 9557, the suspension of FINRA membership, or a FINRA membership that has been effective for less than 12 months, among other criteria set forth in the proposed supplementary material. Activity-based criteria such as market-making and trading activities, and the handling of customer funds or securities can also be surveilled through firm submissions, and other data sources and internal systems.

FINRA recognizes that firms are using increasingly sophisticated technology and analytic techniques to synthesize data in ways not previously possible to identify indicators of possible rule violations and associated person misbehavior. To keep pace with the technological environment, FINRA's regulatory programs are also data driven, and FINRA uses its data and information (e.g., Forms U4 and U5, regulatory tips, transaction reporting, and other internal and externally-acquired data), gathered, in part, through advanced analytics, to better identify and address risks that can be marked not only to a member firm, but also to a registered person. The picture that the data and information reveal may initiate an examination separate from the firm's routine examination or, through Risk Monitoring, further inquiry with the firm.

In the context of the proposed remote inspections pilot program, FINRA would use the risk markers identified using its analytic techniques to inform FINRA's Risk Monitoring and Examinations' assessment of whether FINRA should examine an office or location, and in turn, examine a firm's

<sup>99</sup> See note 49, *supra*.

<sup>100</sup> See Rule 3110(a).

<sup>101</sup> See generally FINRA Examination and Risk Monitoring Programs, <https://www.finra.org/rules-guidance/key-topics/finra-examination-risk-monitoring-programs>.

<sup>102</sup> The five business models are Capital Markets, Carrying and Clearing, Retail, Trading and Execution, and Diversified.

reasonableness determination to conducting remote inspections rather than an on-site inspection for that office or location. Some risk markers may include, among others, CRD disclosures, the number and types of OBAs of registered persons at a specific office or location, the existence and type of investor harm events that have occurred for individuals at an office or location, the historical results and frequency of FINRA's examination of an office or location, and the percentage of senior investors in the county in which the office or location reside, among others. Relatedly, FINRA is able to leverage this data and information when assessing the reasonableness of a firm's supervision, including their determination to inspect an office or location through a remote process, rather than an on-site process. For example, if the data and information identify an office or location with a concentration of OBAs or investor harm events and review of the firm's remote inspection program does not appear to account for OBAs or sales risks, there may be an overall weakness in the firm's inspection program, irrespective of whether the inspection is done remotely or on-site. As with any new process or rule, FINRA anticipates undertaking a careful review of firm compliance with proposed Rule 3110.18. FINRA is engaged in ongoing efforts to enhance its regulatory programs, with a sustained focus on effectively identifying and addressing areas of risk by firm and registered person. Several of FINRA's key functions provide early warning indicators of potential problems, which FINRA leverages in its regulatory oversight of firms. In the context of reviewing a firm's remote inspections program, one indicator in this evaluation may be whether the firm is identifying risk indicators that are similar to those that FINRA is detecting.

#### B. FINRA's Use of the Data and Information Collected in Accordance With Proposed Rule 3110.18(h)

In general, proposed Rule 3110.18(h) would require a pilot program participant to provide FINRA with specified data and information (in an aggregated form), including written supervisory procedures for remote inspections, that FINRA believes would complement FINRA's existing regulatory intelligence as part of the larger effort to gauge the effectiveness of remote inspections as part of a reasonably designed supervisory system. For purposes of its regulatory programs and if appropriate, FINRA may, after some experience with the data and information collected,

extrapolate trends and practices in this area that could result in future rulemaking or updated guidance about inspections generally.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a *Regulatory Notice*.

#### 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>103</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

The terms of the proposed voluntary, three-year remote inspection pilot program, while based largely on the terms of Rule 3110.17, which has been operational since the latter part of 2020 and is set to automatically sunset on December 31, 2023,<sup>104</sup> would include important safeguards that would require individual risk assessments of each office, supplemental written supervisory procedures related to remote inspections, documentation requirements and obligations to share data with FINRA to allow for assessment of the pilot program. The proposed rule change is intended to provide firms that are operating in a hybrid work environment the option to conduct remote inspections of their offices and locations, subject to specified conditions, while maintaining effective supervision. FINRA believes that the proposed pilot program would provide FINRA the appropriate amount of time and population sample to better evaluate the use of remote inspections in the unfolding office work environment. FINRA believes the proposed pilot program, with the proposed safeguards and controls, will provide firms more flexibility to adapt to changing work conditions. The proposed pilot program would aid in FINRA's assessment of the effectiveness of a flexible remote inspection option and its utility in an environment that is increasingly moving to hybrid workplace models, without compromising investor protection.

#### B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not

necessary or appropriate in furtherance of the purposes of the Act.

#### Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet FINRA's regulatory objectives.

##### 1. Regulatory Need

The proposed pilot program would serve two purposes. First, it would mitigate potential disruptions to the hybrid work arrangements that have developed during the pandemic. In particular, for participating members, the proposed pilot program would limit the increase in aggregate inspection costs, and the resulting incentive to reduce the number and type of work locations, that would occur when temporary relief provided during the pandemic expires.<sup>105</sup> The proposed pilot program would not eliminate the need for such adjustments, but it would allow member firms to focus their on-site inspections on riskier locations.

The proposed pilot program would also allow FINRA to assess the benefits and costs of allowing some element of remote inspection of branch offices and non-branch locations, under specified conditions, in the post-pandemic world. FINRA would obtain information from participating members on certain elements of the risk-based approach that they implement, the type and frequency of inspections, and certain outcomes conditional on the type and frequency of inspections, as well as the type of office or location inspected.

##### 2. Economic Baseline

The economic baseline for the proposed rule change includes both current and foreseeable workforce arrangements and business practices, including those that were first developed during the pandemic and have been modified since. In particular,

<sup>105</sup> According to the April Survey of Working Arrangements and Attitudes (SWAA), post-COVID, many employers are planning to allow employees to work from home approximately 2.2 days per week, on average. See Jose Maria Barrero, Nicholas Bloom, Shelby Buckman & Steven J. Davis, SWAA February 2023 (February 12, 2023), [https://wfhresearch.com/wp-content/uploads/2023/02/WFHResearch\\_updates\\_February2023.pdf](https://wfhresearch.com/wp-content/uploads/2023/02/WFHResearch_updates_February2023.pdf). The SWAA is a monthly survey with respondents that are working-age persons in the United States that had earnings of at least \$10,000 in 2019. Further details about this survey can be found in <https://wfhresearch.com>.

<sup>103</sup> 15 U.S.C. 78o-3(b)(6).

<sup>104</sup> See note 49, *supra*.



the economic baseline includes the innovations, and investments in communication and surveillance technology, that have supported and continue to support supervision in the remote work environment.<sup>106</sup> These innovations and investments were developed during the temporary relief allowing remote inspections in Rule 3110.17, and the temporary suspension of the requirement to submit branch office applications on Form BR for new office locations provided in *Notice 20–08* (“Form BR Relief”). The baseline includes the scheduled expiration of Rule 3110.17 on the effective date of the proposed Rule 3110.18; and, in order to provide a full accounting of the likely effects of the proposed rule change, the analysis also assumes that, going forward, the temporary suspension of the above requirement is no longer in effect. FINRA expects that numerous additional office locations would then need to be registered, greatly expanding the number of inspections, and all inspections would then need to be conducted on-site.

As of December 31, 2022, FINRA’s membership included 3,381 firms with 150,495 registered branch offices.<sup>107</sup> Of these branch offices, 18,564 (12%) are OSJs subject to an annual inspection requirement. The remaining 131,931 branch locations are non-OSJ branch offices subject to an inspection requirement at least annually or every three years. In addition, according to FINRA estimates, there are approximately 59,830 non-branch locations, of which 41,078 are private residences.<sup>108</sup> A non-branch location must be inspected on a periodic schedule, presumed to be at least every three years. These data may be affected

<sup>106</sup> The pandemic propelled increased reliance on technology solutions in the remote work environment. A McKinsey survey in late 2020 found that, overall, firms had accelerated their adoption of technology, with large accelerations in the implementation of changes to increase remote working and collaboration, as well the use of advanced technologies in operations. See McKinsey & Company, *How COVID–19 has pushed companies over the technology tipping point—and transformed business forever* (October 5, 2020), <https://mck.co/3nK8b2>.

<sup>107</sup> This count excludes firms with membership pending approval, and withdrawn or terminated from membership.

<sup>108</sup> Non-branch locations do not have to be registered with FINRA. The estimates for non-branch locations, including those that are also private residences, are obtained by reviewing Form U4. There may be some double counting of non-branch locations if members record the address differently on more than one Form U4. For the estimate of non-branch locations, FINRA counted, by firm, unique addresses based on the first seven characters of the Form U4 “Street 1” field, city and state. Addresses that matched the address of the main office or of an existing registered branch were excluded.

by the temporary relief from certain requirements to update Form U4 and to submit Form BR provided in *Notice 20–08*. FINRA estimates that member firms conduct at least 82,500 inspections per year.

### 3. Economic Impacts

When the Form BR Relief ends,<sup>109</sup> FINRA expects that numerous additional office locations will need to be registered, greatly expanding the number of inspections, and all inspections would then need to be conducted on site. The economic impacts of these changes would be mitigated by the proposed rule change for firms that choose to participate in the pilot program.<sup>110</sup>

The requirements in the Proposed Rule 3110.18 would exclude some member firms entirely or partially by excluding some of their offices or locations from participating in the Remote Inspections Pilot Program. The proposed additional requirements reference events or activities of a member firm or its associated person where remote inspection may result in an increased risk to investors.

Using CRD data as of early November 2022, FINRA estimates that under the firm level exclusions from the Initial Proposal, at least approximately 128 firms with 474 registered branches would not qualify for the proposed pilot program. Under the office or location level exclusions, an additional 868 registered branch offices belonging to 278 other firms would be excluded. Thus, a total of approximately 1,342 (= 474 + 868) registered branch offices would be excluded from the proposed

<sup>109</sup> When appropriate, FINRA will announce a termination date for the regulatory relief set forth in *Notice 20–08* that will provide members with time to make necessary operational adjustments. See generally FINRA’s Key Topic: COVID–19/ Coronavirus (referencing, among other things, Frequency Asked Questions Related to Regulatory Relief Due to the Coronavirus Pandemic), <https://www.finra.org/rules-guidance/key-topics/covid-19/faq>.

<sup>110</sup> Separately, FINRA filed a proposed rule change to establish a Residential Supervisory Location (“RSL”), a new non-branch location, that would, relative to the baseline, reduce the number of inspections that members with RSLs would need to conduct in a year. See Securities Exchange Act Release No. 97237 (March 31, 2023), 88 FR 20568 (April 6, 2023) (Notice of Filing of File No. SR–FINRA–2023–006) (“2023 RSL Rule Filing”). For member firms with locations that would meet the proposed definition of an RSL, the aggregate cost savings from choosing to participate in the proposed pilot program would be lower if the RSL proposal were in place because the cost savings from remote inspections would accrue over fewer inspections. The qualitative impacts of the proposed pilot program, however, are similar whether the proposed definition of an RSL is adopted or not.

pilot program.<sup>111</sup> Based on these figures, FINRA anticipates that at most approximately 2,884 small firms, 183 mid-size firms and 166 large firms could potentially participate in the proposed pilot program and that most large firms would have some branch offices excluded.

Participants in the pilot program would be expected to take a risk-based approach to conducting remote inspections. A firm that does not conduct a remote inspection for an office or location must conduct an on-site inspection of that office or location on the required cycle and remains subject to the other requirements of Rule 3110(c). A firm that chooses to participate in the pilot program (assuming that it is not otherwise ineligible from participating) would also be required to provide FINRA with certain data and other information about the risk-based approach that they implement, the type and frequency of inspections, and certain outcomes conditional on the type and frequency of inspections.

### Anticipated Benefits

The benefit to eligible firms of choosing to participate in the pilot program, in an improved health environment, would result from limiting the increase in travel costs and lost productivity due to time spent during travel and in the on-site inspection. On-site visits have material costs from travel expenses and additional staff time. A system of risk-based on-site and remote inspections will allow firms to more efficiently deploy compliance resources and to use an on-site component only when appropriate.

Firms as well as investors may benefit if remote inspections provide new flexibility in the design of inspection teams. For example, remote inspections may facilitate the development of specialized inspection staff that are deployed over more inspections, for shorter periods of time, in a targeted way. This option may especially benefit diversified member firms with a variety of product offerings. Remote inspections can also facilitate the use of inspections

<sup>111</sup> Approximately 1,766 firms have a single registered branch office and ten or fewer registered representatives or no registered branch offices. FINRA anticipates that such firms would be less likely to elect to participate in the proposed pilot program. The reason is that it is less likely that these firms would have enough staff working from home such that the benefit of conducting remote inspections relative to the cost of sending data to FINRA and meeting the other proposed pilot program requirements would make participation in the proposed pilot program more practical than conducting physical inspections or eliminating remote work.

that target a particular area of focus in a member firm's business across all branches of the member firm.

The proposed rule change may also support the competitiveness of the broker-dealer industry for individuals who seek professional positions in compliance.<sup>112</sup> The expectation of workplace flexibility and remote work by such individuals may lead them away from the broker-dealer industry if other segments of financial services or professional occupations offer more flexible workforce arrangements, with regulatory frameworks that offer more discretion in how the supervision is conducted.<sup>113</sup> Even prior to the pandemic, the scope of on-site inspections had been much reduced due to technological surveillance solutions and centralization of books and records. The proposed pilot would support continued adoption and innovation in technological solutions and reductions in the cost of these solutions.<sup>114</sup>

Participants in the proposed pilot program would provide FINRA with quarterly data on the frequency and type of inspections (on-site or remote), counts of findings from inspections subdivided by category of office or location, qualitative information about these findings, and certain information about the written supervisory procedures for remote inspections they are required to have.<sup>115</sup> Depending on

the number and types of firms that participate in the proposed pilot program, this data may allow FINRA to identify differences in risks between remote versus on-site inspection, both conditional on the observable characteristics and policies of firms and overall, the extent of variation in these risks across firms and firm characteristics, and factors associated with very high or low risks.<sup>116</sup> The proposed pilot program has the potential to yield a more thorough collection of sensitive information in a structured manner than voluntary submissions or a survey of FINRA members could provide. This data will be useful both for monitoring for risks as the pilot proceeds and, with sufficient participation, for developing a balanced assessment of the potential impact of permitting further remote inspection.

#### Anticipated Costs

Participation in the proposed pilot program is voluntary, and the proposed rule change provides firms with an additional method for complying with certain supervisory requirements without removing other methods of compliance. Eligible pilot program participants will therefore participate in the pilot program only if doing so is beneficial to their operations relative to complying with current Rule 3110. The cost of complying with the requirements of the proposed pilot program is a factor in this decision. These costs include conducting risk-based analyses for inspections and providing aggregated data on findings to FINRA. The data request in particular may require more standardization and aggregation of inspection findings than some member firms typically conduct. The data request may also not use the same terms or formats used by compliance officers for reporting and tracking inspection findings. Firms may need to develop new written supervisory procedures and new trainings for compliance staff to ensure that all required data is accurate and compiled and submitted to FINRA in a timely manner. Firms will incur new ongoing costs both for compliance and monitoring for compliance.

Supervision and inspections are intended to identify not only the activities that violate member procedures or FINRA rules but also poor practices that might ultimately allow for such violations. FINRA recognizes that

remote inspections may be less likely to identify such practices or activities as on-site inspections. FINRA believes that risks to member firms and investors from remote inspections are mitigated by the proposed requirements to have written supervisory procedures for remote inspections, the proposed requirement to conduct and document risk assessments, the proposed limitations on the firms and locations that would be eligible to participate in the proposed pilot program, and the technology already employed for day-to-day supervision. In addition, FINRA will continue to closely monitor the outcomes of examinations during the pilot program period.

#### 4. Alternatives Considered

The proposed pilot program would continue for three years. FINRA staff considered alternative durations for the program. FINRA members firms vary by business model and organizational structure, so a shorter program is less likely to yield enough data on inspection findings to allow for meaningful comparisons between on-site and remote inspection regimes across members. In addition, inspections are typically planned by members well ahead of time, so some members may not implement the requirements of the program until well into the duration of the pilot program. It may also help firms and the policy development process if FINRA had enough data to meaningfully evaluate well ahead of the expiration of the pilot program.

As discussed above, the requirements in proposed Rule 3110.18 would exclude some member firms entirely or partially by excluding some of their offices or locations from participating in the proposed pilot program. FINRA considered alternative pilot programs with fewer such exclusions. Firms that are entirely or partially excluded that would otherwise participate in the proposed pilot program do not incur a cost relative to the baseline, but they fail to receive the benefits of alternative programs in which they would choose to participate. Restrictions that exclude these firms not only limit the benefits of the pilot program but also limit the potential learnings from the proposed program. As a result, the same restrictions may ultimately need to be carried over into any ongoing program of risk-based examinations. The exclusion of such firms, however, should reduce any risk of customer

<sup>112</sup> See note 106, *supra*. See also Jose Maria Barrero, Nicholas Bloom & Steven J. Davis, Why Working from Home Will Stick (NBER Working Paper 28731, April 2021), <https://wfhresearch.com/wp-content/uploads/2021/04/w28731-3-May-2021.pdf>, who point to a lasting effect of the pandemic on work arrangements, in particular for those with higher education and earnings; and Alexander Bick, Adam Blandin & Karel Mertens, Work from Home Before and After the COVID-19 Outbreak, (Working Paper, October 2022), [https://karelmertens.com.files.wordpress.com/2022/11/wfh\\_oct\\_15\\_paper.pdf](https://karelmertens.com.files.wordpress.com/2022/11/wfh_oct_15_paper.pdf), who find consistent results, with a higher adoption rate of work from home jobs in Finance and Insurance, relative to other industries, reflected in Figure 10. Both papers, based on different surveys and, in Bick et al., with added results from a model, conclude that around 22% of full workdays will be provided from home in the long run.

<sup>113</sup> For example, Advisers Act Rule 206(4)-7 does not require Registered Investment Advisers to conduct in-person inspections or reviews of its offices or personnel.

<sup>114</sup> See Ben Charoenwong, Zachary T. Kowaleski, Alan Kwan & Andrew Sutherland, RegTech (MIT Sloan Research Paper 6563-22, September 16, 2022), <http://dx.doi.org/10.2139/ssrn.4000016>. The authors show that broker-dealers that made compliance technology investments in response to the 2014 amendment of Exchange Act Rule 17a-5 were able to make complementary technology investments in communications and customer relationship management software. These resulted in a reduced number of complaints and less employee misconduct.

<sup>115</sup> In addition, if the effective date of the rule is such that the first year of the pilot program covers a period less than a full calendar year, participating

firms would be required to provide, the data and information specified in proposed Rule 3110.18(h)(2).

<sup>116</sup> In addition, analysis of trends over time will need to consider changes in the macroeconomic environment.

harm from not having on-site inspections.<sup>117</sup>

In addition, FINRA considered the merits of adapting other requirements similar to those FINRA has proposed in the 2023 RSL Rule Filing.<sup>118</sup> In particular, the 2023 RSL Rule Filing is proposing to impose limitations on the offices or locations that may be designated as an RSL. One limitation is that an office or location at which an associated person has less than one year of supervisory experience with the firm or is functioning as a principal for a limited period in accordance with Rule 1210.04 (Requirements for Registered Persons Functioning as Principals for a Limited Period) would be ineligible for RSL designation. FINRA believes that adding these limitations to this proposed rule change would not be appropriate because the presence of even one such associated person at an office or location would disqualify an office or location of any size from participating in the proposed pilot program. FINRA believes that imposing these limitations in this proposed rule change would adversely impact the potential population of pilot program participants, which would then negatively impact FINRA's data and information collection efforts to gauge the effectiveness of remote inspections in a hybrid work environment. Moreover, FINRA believes that this proposed rule change provides for the appropriate controls for participation in the proposed pilot program.

Finally, FINRA considered different levels of detail for the data reporting requirement. FINRA has tried to carefully balance the reporting burden for firms with the need for enough information to make statistically valid comparisons. Nevertheless, depending on the number and type of pilot program participants, interpretation of the results will be subject to caveats.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The SEC published the 2022 Remote Inspections Pilot Program Rule Filing

<sup>117</sup> See Zachary T. Kowaleski, Andrew G. Sutherland & Felix W. Vetter, Supervisor Influence on Employee Financial Misconduct (Working Paper, July 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3646617](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3646617). This paper presents evidence that could be interpreted as supportive of the exclusions based on misconduct and lack of experience.

<sup>118</sup> See note 110, *supra*. FINRA previously filed a similar proposed rule change with the SEC to adopt proposed Rule 3110.19, which FINRA withdrew on March 29, 2022. See <https://www.finra.org/sites/default/files/2023-03/sr-finra-2022-019-withdrawal.pdf>.

for comment and as of the end of the comment period on September 6, 2022, the SEC had received 24 comment letters, then subsequently received four more new comment letters.<sup>119</sup> On November 10, 2022, the Commission instituted proceedings to determine whether to approve or disapprove the 2022 Remote Inspections Pilot Program Rule Filing ("Order"), and the SEC received five comments letters in response to the Order.<sup>120</sup> On December 15, 2022, FINRA filed Partial Amendment No. 1 and responded to the comment letters.<sup>121</sup> On December 22, 2022, the SEC published the partial amendment to the 2022 Remote Inspections Pilot Program Rule Filing for comment and as of the end of the comment period on January 12, 2023, the SEC had received four comment letters.<sup>122</sup> On April 11, 2023, FINRA withdrew the 2022 Remote Inspections Pilot Program Rule Filing to consider whether more safeguards and clarifications to the filing would be appropriate in response to concerns raised by commenters. While the proposed rule change retains many of the terms set forth in the 2022 Remote Inspections Pilot Program Rule Filing, the proposed rule change makes some adjustments, which are discussed in detail above under Item II.A.1(IV).

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act.

<sup>119</sup> See note 52, *supra*.

<sup>120</sup> See Securities Exchange Act Release No. 96297 (November 10, 2022), 87 FR 68774 (November 16, 2022) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove File No. SR-FINRA-2022-021).

<sup>121</sup> See Exhibits 2b and 2c.

<sup>122</sup> See note 52, *supra*.

Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2023-007 on the subject line.

#### Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2023-007. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. Do not include personal identifiable information in submissions; you should submit only information that you wish to make available publicly. We may redact in part or withhold entirely from publication submitted material that is obscene or subject to copyright protection. All submissions should refer to File Number SR-FINRA-2023-007 and should be submitted on or before May 25, 2023.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>123</sup>

**Sherry R. Haywood,**  
Assistant Secretary.

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<sup>123</sup> 17 CFR 200.30-3(a)(12).