



December 7, 2022

Submitted by SEC Webform (<http://www.sec.gov/rules/sro.shtml>)

Sherry R. Haywood
Assistant Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. SR-FINRA-2022-021: Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)

Dear Ms. Haywood:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I am writing in response to U.S. Securities and Exchange Commission (“SEC” or the “Commission”) Release No. 34-96297, *Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)*.² NASAA opposes the proposed rule change (the “Proposal”)³ and encourages the Commission to withhold approval until FINRA has collected the data and other information necessary to justify such a dramatic change to firms’ longstanding supervisory obligations. If the Commission is nonetheless inclined to allow the Proposal to move forward, it should not be adopted without certain changes, including at least those described below.

¹ Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA’s membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

² The Order Instituting Proceedings is available at <https://www.sec.gov/rules/sro/finra/2022/34-96297.pdf>.

³ See *Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)* (the “Notice”), SEC Rel. No. 34-95452 (Aug. 9, 2022), available at <https://www.sec.gov/rules/sro/finra/2022/34-95452.pdf>.

I. The Proposal is not well supported and could lead to undetected investor harm.

NASAA filed a previous comment letter addressing the Proposal on August 23, 2022.⁴ We reiterate and incorporate our previous comments here, including our recommendation that the SEC reject the Proposal because it is not well supported and could lead to unintended investor harm. As we explained in our earlier letter, the Proposal would significantly change how firms carry out fundamental supervisory responsibilities, but it does not establish a sufficient record to support the need for or acceptability of such a change.

In particular, the very basis for the Proposal is the lack of data about broker-dealer firms' experiences with supervision of remote employees.⁵ The Proposal does not include such data, despite most firms operating remotely (including supervision) for more than two and a half years due to relief granted in the early days of the pandemic.⁶ Further, although the industry has repeatedly claimed to have supporting data, they have not shared it with NASAA. FINRA justifies the Proposal by referring to generic "advancements in technology,"⁷ but does not explain how these technologies enable effective remote inspections or the degree to which these technologies are actually being used by member firms of varying sizes and sophistication. In short, FINRA offers no measurable data or quantifiable information to support assertions that these technologies are effective or that its member firms are using them effectively to carry out their supervisory obligations.

Compounding the lack of explanation in the Proposal, FINRA has not, as of the date of this letter, responded to the comments that have already been received on the Proposal. On November 9, 2022, FINRA submitted a letter to the Commission noting that it "is still considering comments" and that it "anticipates submitting a response to comments and amendments to the above referenced rule filing in the near future" (emphasis added).⁸ As a result, the SEC lacks the benefit of FINRA's response to the comments received to date, which should be an integral part of the rulemaking process. FINRA has also indicated that it intends to amend the Proposal, but it is

⁴ Letter from Melanie Senter Lubin, NASAA President and Maryland Securities Commissioner, to J. Matthew DeLesDernier, Assistant Secretary, *Re: File Nos. SR-FINRA-2022-021 and SR-FINRA-2022-019* ("NASAA Letter") (Aug. 23, 2022), available at <https://www.nasaa.org/wp-content/uploads/2022/08/2022-08-23-NASAA-Comment-Letter-on-SR-FINRA-2022-019-and-021-redacted.pdf>.

⁵ See, e.g., Notice at 15-16.

⁶ See, e.g., *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend Temporary Supplementary Material .17 (Temporary Relief to Allow Remote Inspections for Calendar Years 2020 and 2021, and Through December 31 of Calendar Year 2022) Under FINRA Rule 3110 (Supervision)*, SEC Rel. No. 34-96241 (Nov. 4, 2022), available at <https://www.sec.gov/rules/sro/finra/2022/34-96241.pdf> (proposing to extend relief granted in November 2020 and subsequently extended).

⁷ See Notice at 2-3.

⁸ See Letter from Sarah Kwak, FINRA Associate General Counsel, to Vanessa Countryman, Secretary, *Re: SR-FINRA-2022-021* (Nov. 9, 2022), available at <https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021-20150525-319585.pdf>.

unclear to us whether any proposed amendments will be subject to meaningful notice and comment.

If enacted as proposed, the Proposal could result in firms failing to detect investor harm, whether past, potential, or ongoing. As recent actions and investigations demonstrate, there is no guarantee that associated persons will use firm systems that purportedly enable remote surveillance.⁹ Many of the same technologies touted as supporting the Proposal can also serve as vehicles to operate outside of firm systems.¹⁰ As NASAA shared in its previous comment letter on the Proposal, in-person inspections often turn up evidence of misconduct in far-flung areas of an office, or in closed drawers. In-person inspectors also notice things that spark questions, such as evidence of a lifestyle that does not accord with an associated person's production. More generally still, in-person inspectors have a better ability to assess the demeanor and candor of their associated persons in ways that are harder to detect on the phone or during a videoconference.

If the pilot program is approved, member firms will have had nearly five and a half years of remote inspections without the Commission receiving data that might support, or refute, the proposed changes. If lax remote inspection practices become the norm, it will be difficult to bring them back up to an acceptable level, regardless of what the data ultimately suggests. At the end of this period, it is likely that some member firms will have grown accustomed to remote supervision and will have modified their business models to rely largely, if not solely, on remote inspections. The Commission should therefore appreciate that the pilot program will likely shape industry norms and practices in such a way that will make it difficult to return to a more rigorous standard with more frequent in-person inspections, even should circumstances show it to be necessary.

In our view, the Commission should avoid this outcome by withholding approval until firms have demonstrated that conducting their inspections remotely will not materially impair

⁹ See, e.g., *In re J.P. Morgan Securities LLC*, SEC Rel. No. 34-93807 (Dec. 17, 2021), <https://www.sec.gov/litigation/admin/2021/34-93807.pdf>; *In re Craig Scott Capital, LLC*, SEC Rel. No. 34-77595 (Apr. 12, 2016) (finding that a brokerage firm violated Regulation S-P when its principals and other employees used personal email addresses to receive faxes that included sensitive customer records and information, as well as by engaging in business communications through personal email accounts). See also Bloomberg, *US Pries Into Over 100 Trader and Banker Phones in Texting Probe* (May 18, 2022), available at <https://www.bloomberg.com/news/articles/2022-05-18/us-pries-into-over-100-trader-and-bankerphones-in-texting-probe#xj4y7vzkg>; Wall Street Journal, *Banks Nearing \$1 Billion Settlement Over Traders' Use of Banned Messaging Apps* (Aug. 19, 2022), available at <https://www.wsj.com/articles/biggest-banks-nearing-1-billion-settlement-over-traders-use-of-whatsapp-other-banned-messaging-apps-11660947521>. Indeed, as the Journal notes, "The practice [of using banned technologies for business communications] became more common – and harder to detect – during the early stages of the pandemic, when employees switched to working entirely from home." *Id.*

¹⁰ See, e.g., Mass. Sec. Div., *In re Summit Equities Inc.*, Consent Order, Docket No. R-2018-0083 (Dec. 26, 2018) (finding that broker-dealer failed to reasonably supervise its representatives when it allowed them to use third-party customer relationship management systems over which firm had no access or control, resulting in the inability to retrieve records, including customer personal identifiable information ("PII"), upon termination of representatives and to prevent terminated representatives from removing such records from the firm and sharing customer PII with unauthorized parties).

investor protection and compliance with the securities laws. As we recommended in our August comment letter on this proposal, the safest way to do so is to require FINRA to conduct an examination sweep, produce a public report of its findings, and offer a proposal consistent with the evidence gathered. However, if the Commission is inclined to allow the Proposal to move forward, the following changes, at minimum, are necessary to reduce the likelihood of investor harm and ensure that both FINRA and the Commission have access to sufficient information to assess its efficacy.

II. The pilot program needs more robust criteria to determine eligibility to participate.

a. Firms should be required to provide baseline data to FINRA.

Firms should be required to provide FINRA with baseline data before they are eligible to participate in the pilot program. Specifically, firms should be required to provide FINRA with the information specified in proposed Rule 3110.18(f) covering the most recent 12-month period during which the firm conducted in-person inspections under Rule 3110(c).¹¹ While such pre-pandemic data will be somewhat dated, it would still be the best control data against which to measure subsequent remote firm inspection efforts. This is necessary because one of FINRA’s main objectives for the Proposal is to “more accurately assess the overall impacts on firms’ supervisory systems to inform FINRA’s application of supervisory requirements to the new work environment, including potentially broader reliance on remote inspections.”¹² The impact to firms – and, more importantly, to investor protection – cannot be assessed effectively unless FINRA has access to both “before” and “after” data. For example, FINRA needs to know whether and how the number of inspections, the number of findings, and the nature of such findings are changing as a result of firm decisions to move away from in-person inspections. This information is critical to any consideration of “potential[] broader reliance on remote inspections” in the future. Given the significance and inherent risk of the changes in the Proposal, we do not believe that this requirement would be unduly burdensome.

b. The Proposal should detail certain minimum standards for a firm’s policies and procedures.

As proposed, any firm would be able to participate in the pilot program as long as it is not designated as a Restricted Firm under Rule 4111 or a Taping Firm under Rule 3170.¹³ As such, a firm’s eligibility to participate would not be in any way dependent on that firm’s ability to discharge its remote inspection obligations effectively. Although FINRA, the SEC, and state

¹¹ To the extent that Rule 3110.18(f) requires data about remote inspections, the firm’s response would likely be “0,” but a firm should include any remote inspection conducted in addition to the required on-site inspection of any location. A firm could also choose to collect this data on a prospective basis before participating in the pilot program.

¹² Notice at 16.

¹³ See Proposed Rule 3110.18(b)(2)(A).

securities regulators have enforcement tools to address a firm's failure to supervise its associated persons, prevention should always be the priority because it is cheaper and more effective. Accordingly, the pilot program should include certain minimum standards for a firm's policies and procedures ("WSPs") before that firm can participate.

As we noted in our earlier letter, the Proposal does not provide any data about the extent to which specific technologies are actually being used by its member firms, relying instead on cautious anecdotal references to what "[s]ome firms have indicated."¹⁴ We are concerned that there may be a disparity in capability and readiness between firms of varying sizes. It is important that every firm in the pilot program – whether a multinational wirehouse, a nationally-dispersed independent broker-dealer, or a smaller regional firm – demonstrate and assure FINRA that it can meet a minimum baseline to protect investors.¹⁵

Among other things, proposed Rule 3110.18 should expressly require that the firm's WSPs meet the following minimum standards:

- Articulate, with specificity, the technologies that the firm would be using for what purposes and provide evidence to show that the firm and its supervisory personnel have sufficient access to and proficiency with those technologies. This should include not only the technology used to monitor sales practices and communications, but also the technology used to ensure that associated persons are not selling away or engaged in unauthorized outside business activities¹⁶ and the technology used to ensure that records are maintained within the firm's access and control.
- Describe the circumstances in which the firm will conduct physical inspections, both in the ordinary course and as a result of risk indicators and red flags. The Proposal correctly recognizes that red flags warrant a heightened supervisory response.¹⁷ A firm's WSPs should provide guidance to supervisory personnel about when an in-person inspection is required or warranted.
- Indicate whether the firm intends to conduct unannounced inspections, how the firm intends to do so remotely, and whether certain factors might influence the firm's

¹⁴ See NASAA Letter at 6 (quoting Notice at 4 n.5).

¹⁵ We acknowledge that many firms of all sizes have conducted remote supervisory activities for the better part of the last two and a half years. However, that does not necessarily mean that any or all firms have done so effectively, nor does it assure that some customer harm has not remained undetected. Emergency measures taken during the early part of the pandemic must be distinguished from measures instituted under the imprimatur of FINRA and the Commission.

¹⁶ With regard to selling away and outside business activities, the Proposal should also expressly state that an internet or social media search alone is *per se* insufficient to satisfy the requirements of FINRA Rule 3110(c).

¹⁷ See Proposed Rule 3110.18(d). As described below, the specific language used in the Proposal is too loose and should be strengthened.

decision to do so in particular circumstances. Regulators understand that unannounced inspections enhance supervision because they “diminish the opportunity for concealment, removal, or destruction of the evidence of misconduct.”¹⁸ The industry should appreciate the same thing and be ready to commit to conducting unannounced inspections in order to be allowed to participate in FINRA’s proposed program.

c. The Proposal should establish minimum technological capabilities.

In the context of the pilot program, certain prescriptive floors are necessary to provide assurance each individual firm has the capabilities to conduct remote inspections effectively. The Proposal should establish certain minimum technological capabilities as a prerequisite for participation in the pilot program. These should include, but not necessarily be limited to, tools that: permit remote access to an associated person’s work computer; prevent an associated person from printing or exporting firm records from firm equipment and systems; and permit video inspections – with mobile cameras – of the entirety of the associated person’s remote work space.

Remote access tools, in particular, are necessary to enable unannounced inspections and to assure that supervisors are not viewing only what the associated person wants to show them. If an associated person is conducting firm business on a device, the firm should be able to conduct a thorough inspection of that device. Videoconferencing technology, and particularly portable cameras, are similarly crucial to a rigorous inspection. It is vital that a supervisor conducting a remote inspection be able to see the entire office, not merely a view of the associated person sitting behind his or her desk or a kitchen counter. These tools should be the bare minimum necessary for a firm to participate safely. These prerequisites should not be sufficient on their own, but a firm’s lack of such capabilities should preclude participation and require that the firm comply with the existing in-person inspection requirements.

d. The Proposal should establish a mechanism for FINRA to deem a firm ineligible.

As proposed, the pilot program does not include a specific mechanism for FINRA to preclude a firm from participating if the firm’s WSPs are inadequate or the firm lacks the requisite technological capabilities and expertise. Under such circumstances, the risk to investors outweighs the potential benefit of the data that that firm might provide. Thus, the Proposal should include a mechanism for FINRA to deem a firm ineligible if FINRA determines, in its discretion, that the firm’s policies and procedures are not “reasonably designed to detect and prevent violations of and achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules” specifically via remote inspections, as well as certain other minimum criteria. Other minimum criteria should include, *inter alia*, a lack of access to the requisite technologies and a demonstrated lack of proficiency with the relevant technologies.

¹⁸ SEC, Staff Legal Bulletin No. 17, Remote Office Supervision (Mar. 19, 2004).

III. The Proposal needs stronger language regarding when in-person inspections are warranted and appropriate.

As we noted in our earlier letter, the Proposal states that FINRA “expects that higher risk factors at a particular location would cause a firm to conduct on-site inspections of such location” and that “where a member’s remote inspection of an office or location identifies any indicators of irregularities or misconduct . . . the member may need to impose additional supervisory procedures for that office or location . . . including potentially a subsequent physical, on-site visit on an announced or unannounced basis.”¹⁹ This is insufficient given the significance of the change to long established supervisory practices that is likely to flow from the pilot program. While not every situation calls for an identical supervisory response, the Proposal should be clearer that the pilot program is not an indication that in-person inspections are only required under extraordinary circumstances, nor an invitation to treat them as such. To this end, the Proposal should clearly describe the circumstances in which an in-person inspection is appropriate or required.

Proposed Rule 3110.18(d) should be revised to replace the vague language referenced above with an affirmative requirement that a firm conduct “a subsequent on-site visit on an announced or unannounced basis” if a remote inspection identifies any red flags,²⁰ or else specifically document its decision not to do so and provide that information to FINRA with the next periodic data delivery. Additionally, the Proposal should provide more detail about what kinds of circumstances warrant such a response. The Proposal acknowledges certain “[r]ed flags that suggest the existence or occurrence of violations, prompting an unannounced visit.”²¹

Regardless of whether FINRA includes the changes described in this section, the Proposal should explicitly require that each firm fully document any decision not to conduct an in-person inspection once red flags have been identified. Such documentation should include the information considered by the relevant personnel and their analysis of that information.

IV. In order to assess the efficacy of the pilot program, FINRA must collect sufficient data and provide periodic, detailed reports to the SEC.

One of the primary goals of the pilot program is to “allow FINRA the time to collect specified data from member firm pilot participants to evaluate their experiences and inspection findings in a uniform, comparable manner in the context of the emerging hybrid work model.”²² In order to achieve this goal, the Proposal must be clearer and more specific about what information firms need to collect and how frequently they need to provide that information to FINRA, as well as what FINRA will do with that data.

¹⁹ See NASAA Letter at 8 (quoting Notice at 18, 24 (emphasis added)).

²⁰ At a minimum, the Proposal should state that a firm “should” do so.

²¹ See Notice at 9-10 n.9.

²² Notice at 15-16.

In order to evaluate data “in a uniform, comparable manner,” it is important for the data to be delivered in such a manner. As proposed, the timing and frequency with which firms would deliver data to FINRA is, in our view, not adequately defined. Firms should be required to provide information to FINRA quarterly, rather than “on a periodic basis (not to exceed quarterly).”²³ In order to ensure that the data is comparable throughout the life of the pilot program, the data should reflect the same time period for all participants and should remain constant. As an initial matter, calendar benchmarks are superior to frequency benchmarks. Data covering different time periods, even if submitted with the same frequency, will hinder the comparability and utility of the data. We believe that quarterly data delivery is optimal. A longer period, such as annual or twice-yearly, would hinder FINRA’s ability to analyze the data effectively and attribute trends and changes to potential external factors, such as market shocks and anomalous events that may, for example, cause the number of customer complaints to rise.

With respect to the data to be collected, we recommend the following changes. First, proposed Rule 3110.18(f)(1)(B) through (D) should specify that the information is to be provided for inspections “during each calendar quarter,” consistent with subparagraph (A). We believe that this was FINRA’s intent, but the current lack of specificity may result in inconsistent data. Second, proposed Rule 3110(f)(1)(E) and (F) should require a list of all findings, not only the ones the firm subjectively deems “most significant.” Leaving this element to the discretion of each individual firm will undermine the uniformity of the data and hinder FINRA’s ability to analyze the data “in a uniform, comparable manner.” Third, proposed Rule 3110(f)(1)(G) should be augmented to include “any other procedures relevant to the conduct and documentation of the risk assessment referenced in paragraphs (a) and (c) of this Supplemental Material” and “any other procedures relevant to the conduct of remote inspections and the documentation of findings under this Supplementary Material.” As proposed, FINRA will only receive part of the overall picture. It is important that FINRA have the data to understand the variance across diverse firms.

Finally, the data collected pursuant to the pilot program is critical to the Commission’s assessment of the pilot program and any subsequent proposed rule change. As such, it is critical that the Commission be informed, as the pilot program unfolds, what kind of data is being developed in support of or refuting the assumptions underlying the Proposal. This includes whether remote supervision appears to be effective and whether participating firms are providing useful data to guide FINRA and the Commission in their respective oversight roles.

All securities regulators agree that vigilant supervision is a necessary and important component of the broader investor protection framework under the state and federal securities laws. Technology has influenced and will continue to affect how firms conduct business and carry out their supervisory responsibilities. Given the significance of these proposed changes and both the nature and magnitude of the potential risk to investors, it is imperative that it be done safely.

²³ See Proposed Rule 3110.18(f)(1).

V. Conclusion

In sum, NASAA opposes the Proposal and encourages the Commission to withhold approval until FINRA has collected the data and other information necessary to justify such a dramatic change to firms' longstanding supervisory obligations. However, if the Commission is nonetheless inclined to allow the Proposal to move forward, it should not be adopted without certain changes, including at least those described above.

Thank you for considering these views. NASAA looks forward to continuing to work with the Commission and FINRA in the shared mission to protect investors. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at (202) 737-0900.

Sincerely,

A handwritten signature in cursive script that reads "Andrew Hartnett".

Andrew Hartnett
NASAA President and
Deputy Commissioner,
Iowa Insurance Division