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

J. Matthew DeLesDernier
Assistant Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. SR-FINRA-2022-021: Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)

File No. SR-FINRA-2022-019: Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110 (Supervision)

Dear Mr. DeLesDernier:

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. 34-95452, *Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)* (the “Pilot Program Proposal”) and Release No. 34-95379, *Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110 (Supervision)* (the “Supervisory Location Proposal”) (collectively, the “Proposals”).² FINRA offers neither a robust basis nor sufficient justifications for either proposal, and we ask the SEC to reject both in favor of a process that would lead to evidence-driven rulemaking.

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 Pilot Program Proposal is available at <https://www.sec.gov/rules/sro/finra/2022/34-95452.pdf>. The Supervisory Location Proposal is available at <https://www.sec.gov/rules/sro/finra/2022/34-95379.pdf>.

Taken together, the Proposals would significantly change how firms carry out fundamental supervisory responsibilities designed to detect and prevent potential investor harm. Underpinning the Proposals is FINRA's largely unsupported assertion that electronic monitoring has advanced sufficiently to allow industry to risk replacing in-person inspections and supervision with unspecified technological alternatives. NASAA disagrees that this is the best approach for a supervisory system. For reasons explained below, state regulators believe that meaningful in-person inspections must remain a part of every firm's supervisory practices. Further, contrary to FINRA's confidence in technology, recent investigations and enforcement actions show that inadequately controlled firm personnel, including supervisors, have used new technologies to evade regulatory responsibilities and potentially engage in misconduct.

In order to propose changes that would alter the basic nature of firm supervision, FINRA should gather sufficient information and facts to demonstrate that such changes are warranted and, more importantly, that such changes can be implemented appropriately. To approve the Proposals in the manner suggested – namely, to allow them to occur under a superficial level of scrutiny – would be improvident at best and could lead to undetected investor harm.

NASAA, therefore, urges the SEC to ask FINRA to embark on a more deliberate and careful approach to these issues. NASAA believes the SEC should reject the Proposals, grant a request to extend temporary relief for one year, and encourage FINRA in that time to: (1) conduct an examination sweep (under the SEC's supervision) to determine the ubiquity and effectiveness of remote supervision policies, procedures, practices and technologies across a wide sample of FINRA member firms; (2) issue a public report that describes FINRA's methods, findings and any recommendations for changes and improvements that could ensure effective remote supervision generally; and (3) based on the record developed, engage in full rulemaking processes for any subsequent proposals, which would include FINRA regulatory notice and comment periods followed by SEC notice and comment periods.

I. Comments Regarding Both Proposals

a. The Proposals Seek Significant Relief Without Adequate Notice and Comment.

The rushed manner in which the Proposals have been offered would force the SEC to grant landmark changes to FINRA member firm supervision responsibilities without an adequate administrative record. By taking the Proposals directly to the SEC, by limiting the comment period for each to 21 days, and by declining in both cases to consent to extensions of time for Commission action, FINRA has precluded the ability of all stakeholders to engage in reasoned and thoughtful consideration of the Proposals. FINRA's approach also deprives the SEC of the insights that would have been generated in a full notice and comment process, as well as any reactions or changes FINRA might have made in response to comments. Finally, by waiting until less than

120 days before the temporary relief granted by the SEC is set to expire, FINRA has injected unnecessary urgency into the Proposals.³

NASAA understands that many firms have and will continue to allow staff to work from home or in hybrid arrangements. We also understand that an abrupt end to temporary relief in December would be jarring. However, FINRA's approach accords too much weight to industry, with very little consideration as to how such changes could impact investors. The immediate conundrum that industry finds itself in is not a good reason to provide relief first and assurances later. Rather, the solution in NASAA's view is to do the work necessary to assess the efficacy of different approaches to these issues, create a record to support potential future rulemaking, and then to follow the proper rulemaking processes.

FINRA may argue that an adequate record has been developed through conversations with industry surrounding remote inspection practices that have taken place leading up to the Proposals. However, conversations mostly with FINRA member firms is not a sufficient basis for the changes FINRA seeks. Until now, FINRA has not offered detailed proposals for the collective consideration of industry, regulators, and other stakeholders. In particular, FINRA Regulatory Notice 20-42⁴ should not be considered as a regulatory precursor to the Proposals because it was merely a retrospective rule review through which FINRA asked generally for "feedback on lessons learned from stakeholders' experiences during the pandemic" and "comment on whether [FINRA] should consider changes to its rules, operations and administrative processes"⁵ Critically, the Regulatory Notice did not propose any specific course of action and solicited anecdotal evidence rather than statistical analyses of the types of harms and number of violations firms discovered through their remote examination programs. NASAA's response to Regulatory Notice 20-42 raised a number of concerns with home work locations, including the following:

Many homes have weak cybersecurity and are not secure places to store physical records. The risks of data loss and the challenges of data recovery are higher for remote workers. Firms also have no control over who is present in a home office. Any discussion of allowing firms and associated persons to custody customer securities or funds in home offices should therefore be viewed skeptically. Further, the likelihood of representatives communicating with customers outside of firm systems is much greater. In short, home offices are not controlled settings in the way that business offices are and, unless and until regulatory controls are

³ NASAA understands that FINRA's Board of Directors approved the Proposals at least as early as March, when they were outlined publicly during the Securities Industry and Financial Markets Association ("SIFMA") 2022 Compliance and Legal Seminar.

⁴ FINRA Regulatory Proposal 20-42 can be found at <https://www.finra.org/sites/default/files/2020-12/Regulatory-Notice-20-42.pdf>.

⁵ *Id.* at 1.

developed to account for those shortcomings, it would be unwise to make current accommodations permanent.⁶

No acknowledgement or reaction to those concerns exists in the Proposals. Yet, this is the very reason that FINRA proposals should go through FINRA-level notice and comment periods before they are brought to the SEC; namely, so that the SEC receives the benefit of FINRA's reactions to comments directed to specific proposals. Instead, what the SEC has before it is a set of unchallenged and untested arguments.

There is, however, one instance in which FINRA made a change to the Pilot Program Proposal in light of concerns expressed by NASAA (and hopefully others). In discussions earlier this year, FINRA staff stated that FINRA intended to offer the pilot program to all firms, regardless of disciplinary history. The Proposals, however, now exclude certain firms from participating based on circumstances including disciplinary history and ongoing regulatory investigations and proceedings.⁷ NASAA greatly appreciates FINRA's transparency and responsiveness on this aspect of its proposed pilot program. However, it should be recognized that the lack of a FINRA-level notice and comment process may mean that concerns held by other stakeholders were not heard and, therefore, do not figure into the Proposals.

b. FINRA Has Not Developed a Record to Support the Proposals.

FINRA asks the SEC to endorse a process that has the steps for proper regulation arranged in reverse; i.e., adopt rule changes first and gather facts later. With respect to the Pilot Program Proposal in particular, FINRA states that a three-year, industry-wide pilot program "would 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."⁸ In other words, FINRA suggests that the pilot program is necessary because it has been unable to gather the data to support its proposals, despite the fact that most of its member firms have been operating remotely for more than two and a half years. NASAA understands that firms already have data regarding their remote inspection practices. To grant FINRA an additional three years to gather data would in effect provide industry with over five and a half years of relief without ever providing the SEC with data that might support, or refute, the proposed rule changes.

NASAA's concern with the prospect of extended and unsupported relief is exacerbated by its frustration in gathering evidence of the effectiveness of remote supervision in the months preceding the Proposals. Specifically, in December 2021 NASAA met with SIFMA representatives who described their reasons for being confident that relief from in-person

⁶ See Letter from Lisa Hopkins, NASAA President, to Jennifer Piorko Mitchell, FINRA Office of the Corporate Secretary, *Re: Regulatory Notice 20-42: Retrospective Rule Review* (Feb. 23, 2021) at 3, available at <https://www.nasaa.org/wp-content/uploads/2021/02/Comment-Letter-FINRA-RN-20-42-022321.pdf>.

⁷ See Pilot Program Proposal at 19-21 and Supervisory Location Proposal at 28-32.

⁸ See Pilot Program Proposal at 15-16.

inspections could be accomplished safely. They based these claims on purported data that they did not subsequently provide upon request. In May 2022, NASAA again met with SIFMA representatives during a meeting of our Broker-Dealer Section Committee. Representatives from NASAA specifically asked for the data being referred to, but again no data was forthcoming. Ultimately, SIFMA told the SEC last month that it is now conducting a survey of its members that it will release “in August or early September.”⁹ It is unclear how statistically rigorous this survey will be, or whether it could possibly be tested or be of use before FINRA seeks to have its Proposals adopted.

Also concerning has been FINRA’s failure to build a record to support its proposals during this period. FINRA could have requested or compelled data on remote inspection practices at any time. Further, beginning at least as early as October 2021, NASAA staff held discussions with FINRA staff, including staff from its Office of the Chief Economist, regarding a survey FINRA was purportedly drafting to learn the state of firm remote inspection practices. NASAA was invited to provide input, which we did in the form of a set of questions to include in a survey that we believed would be designed to ascertain the effectiveness of remote inspection practices.¹⁰ FINRA declined to use NASAA’s questions, citing “state actor” concerns. To our knowledge, FINRA did not conduct a survey of any kind.

c. The Proposals Are Based on Unsupported Assumptions about the Use and Effectiveness of Technology.

The Proposals tout advances in technology but provide almost no detail as to why such advances are sufficient to allow firms to conduct remote inspections solely, or to lessen the frequency of inspections of supervisory offices.¹¹ These bare statements are insufficient bases upon which to grant the relief requested.

Even as a matter of descriptions without data, FINRA’s references to technological advances fail to offer the necessary support for several reasons.¹² First, FINRA does not describe with specificity the technologies it believes are being employed to conduct effective remote

⁹ See Letter from Kenneth Bentsen Jr., SIFMA President and CEO, to Gary Gensler, SEC Chair, *Re: Extension of Temporary Supplementary Material .17 (Temporary Relief to Allow Remote Inspections for Calendar Years 2020 and 2021, and Through June 30 of Calendar Year 2022) under FINRA Rule 3110* (July 15, 2022).

¹⁰ See Exhibit A.

¹¹ A typical statement from the Pilot Program Proposal posits that “[o]ver 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 an on-site inspection requirement.” Pilot Program Proposal at 2.

¹² The strongest support found in the Pilot Program Proposal is a citation to a 2018 survey of industry technologies. See FINRA White Paper, *Technology Based Innovations for Regulatory Compliance (“RegTech”) on the Securities Industry* (September 2018), https://www.finra.org/sites/default/files/2018_RegTech_Report.pdf. It is fair to say, however, that the 2018 survey describes the capabilities of these technologies in general, but does not describe in detail how widely they are used, nor does it provide evidence of their effectiveness in controlling the behavior of firm employees operating in remote environments.

surveillance. Second, FINRA provides no data about the degree to which such technologies are actually being used by its member firms. Instead, FINRA provides cautious anecdotal references to what “[s]ome firms have indicated” about their uses of technology.¹³ That may mean that FINRA does not know how widespread remote surveillance technologies are among its members. Further, FINRA has provided no evidence that such technologies are in fact being used by both larger and smaller firms and, therefore, the SEC cannot know whether robust remote inspection technologies are cost effective for smaller firms.¹⁴

Third, FINRA has not identified any recent advances in technology that materially improve the ability of firms to perform remote inspections among highly dispersed personnel, other than obvious references to such things as Zoom. This last point is important because the Proposals do not account for the likelihood that some dispersed associated persons will actively work to avoid firm surveillance. FINRA offers insufficient explanations as to how or whether remote supervision technologies can address active misconduct. As is explained below, the recent experience of the SEC with non-firm approved communications services, and the perennial experience of regulators, is that associated persons can and do actively avoid firm monitoring, and the best countermeasure has been to interact with firm staff in person.

d. Recent Enforcement Actions and Investigations, as Well as Perennial Failures by Firms to Use Technological Controls Effectively, Show that Technology Cannot Guarantee Compliant Behavior.

Technological advancements are meaningless when firms or their associated persons choose not to comply with regulations. Recent events indicate that the misuse of technologies by dispersed personnel is a problem even for large firms with immense resources. For instance, as the SEC found last December when it imposed a \$125 million fine on J.P. Morgan Securities LLC,¹⁵ the firm admitted that for more than two years its employees often communicated about securities business matters on their personal devices, using text messages, WhatsApp, and personal email accounts. The SEC also found that supervisors were among the offenders. In fact, the SEC is coming to understand that this problem is endemic across the financial services industry. According to news reports, the SEC has investigated the use of non-firm communications services

¹³ Pilot Program Proposal at 4, n.5.

¹⁴ At least one commentator has noted that the Pilot Program Proposal could drive smaller firms to merge or become acquired. See InvestmentNews, *New regulations for the new reality* (Aug. 22, 2022), <https://www.investmentnews.com/new-regulations-monitor-remote-work-for-the-new-reality-225579>. If that reasonable observation is correct, then the SEC needs to contemplate whether the Pilot Program Proposal should be rejected because it may be anti-competitive, or because it may limit customer choice by driving smaller firms out of business.

¹⁵ *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>.

among some of the largest firms and is nearing a series of significant settlements for firm failures to ensure compliance with recordkeeping practices.¹⁶

It should come as no surprise that such misconduct is nothing new, and examples abound.¹⁷ Moreover, more contemporary examples show that technology in and of itself does not prevent misconduct, and in fact can be the means through which new forms of misconduct occur.¹⁸ To the extent that practices such as working from home become ubiquitous, so too the risk of firms and associated persons mishandling records will become a greater threat to compliance. To posit, as the Proposals suggest, that firms now have the technology to seal the activities of their associated persons' activities into firm systems is not realistic. FINRA offers no reason to believe that the technological advancements they are touting are effective, and no reason to believe that firms are using such technologies effectively to control their personnel. Against this backdrop, giving

¹⁶ See 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-banker-phones-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.*

¹⁷ 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); *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).

¹⁸ See *In re KMS Fin. Servs., Inc.*, SEC Rel. No. 34-92807 (Aug. 30, 2021), <https://www.sec.gov/litigation/admin/2021/34-92807.pdf> (noting, in the context of finding that firm had responded inadequately to notice that cloud-based email account had been compromised, that the firm's "independent contractors, including financial advisers and their assistants, generally used their own computer equipment and networks, including protective infrastructure and software, such as encryption, antivirus protection, and local password storage requirements"); *In re Cetera Advisor Networks LLC, et al.*, SEC Rel. No. 34-92800 (Aug. 30, 2021), <https://www.sec.gov/litigation/admin/2021/34-92800.pdf> (finding that respondents had responded inadequately to notice that cloud-based email accounts had been compromised, resulting in the exposure of customer PII, and noting that some of the accounts "were provisioned and managed by branch offices where the representatives worked"); *In re Cambridge Inv. Res., Inc. and Cambridge Inv. Res. Advisors, Inc.*, SEC Rel. No. 34-92806 (Aug. 30, 2021), <https://www.sec.gov/litigation/admin/2021/34-92806.pdf> (finding that respondents had responded inadequately to notice that cloud-based email accounts had been compromised, and noting that "[a]lthough some of the independent representatives followed Cambridge's recommendation and implemented [multi-factor authentication], many did not"). See also, e.g., Letter of Acceptance, Waiver and Consent No. 2020067908701, *Zachary Hansen* (FINRA, Aug. 11, 2022) (finding that from 2018 to 2020, respondent used a personal cell phone to communicate with customers about securities recommendations, account performance and transactions, and market events, despite being prohibited in the firm's policies and procedures); and Letter of Acceptance, Waiver and Consent No. 2019064955001, *Yan Binder* (FINRA, Aug. 18, 2022), (finding the same misconduct as immediately above between 2018 and 2019, and finding that respondent received reminders in 2017 about the need to refrain from communicating with customers about securities business via text message).

almost all member firms a license to abandon in-person inspections of branch offices and other remote locations once pandemic conditions are no longer an issue is problematic.

II. Comments on the Pilot Program Proposal

a. FINRA's Proposed Controls Are Insufficient.

FINRA's failure to build a record to support the Proposals should leave the SEC concerned that the Proposals are not well-founded. It should also cause the SEC to scrutinize how well FINRA purports that it will screen firms for its pilot program and monitor their compliance. The Pilot Program Proposal does not offer controls stringent enough to allow FINRA to effectively monitor firms during the proposed pilot program.

For instance, the Pilot Program Proposal would require firms to maintain written policies and procedures sufficient to allow a firm to participate in the pilot program, and to provide certain data about its remote inspection activities to FINRA.¹⁹ However, the Pilot Program Proposal does not provide any prescriptive details as to how rigorous those policies and procedures must be in order to pass muster. Instead, the Pilot Program Proposal offers a principles-based formula that such policies and procedures must be “reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations, and with applicable FINRA rules.”²⁰ Further, firms will be able to make subjective judgments as to which of their offices can be inspected remotely, and the risk assessments that support those choices.²¹ With respect to when in-person inspections would be appropriate, FINRA loosely states that it “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.”²² With such tepid language, firms may regard the need for in-person inspections to be reserved for only the most extraordinary risks. That would be unfortunate. Previous SEC staff guidance has been more forthright and clear-eyed about when and why in-person inspections are appropriate.²³ Even for dispersed workforces, in-person inspections should be an ordinary part of a firm’s supervision practice. The Pilot Program

¹⁹ Pilot Program Proposal at 25 and 27.

²⁰ *Id.* at 22.

²¹ *Id.* at 17-18.

²² *Id.* at 24 (emphases added).

²³ SEC, Staff Legal Bulletin No. 17, *Remote Office Supervision* (Mar. 19, 2004) (stating that: “[t]he Commission has determined that broker-dealers that conduct business through remote offices have not adequately discharged their supervisory obligations where there are no inspections of those offices;” “encourag[ing] firms to use unannounced, onsite inspections of remote offices;” and stating that “a supervisor is more likely to uncover evidence of misconduct in customer files, such as fictitious account statements, during an unannounced inspection than in an announced inspection that gives the representative an opportunity to remove such documents from customer files”).

Proposal signals to firms that FINRA will accept firm decisions to largely abandon in-person inspections. Further, FINRA does not clearly specify what shortcomings – other than the failure to provide data – would cause FINRA to reject a firm’s bid to conduct all inspections remotely. NASAA is concerned that FINRA is not being sufficiently demanding in its criteria. The Pilot Program Proposal is written in a way that leaves FINRA too much room to be lenient.

This leniency extends into FINRA’s monitoring efforts during the pilot program. The Pilot Program Proposal does not specify any efforts FINRA would undertake during the pilot program period to monitor firm activities to ensure that they are acting in compliance with their policies and procedures, except in the most general terms. The only sort of monitoring that is clear is that FINRA will gather data. The Pilot Program Proposal does not describe any efforts FINRA would undertake to make sure that any firm’s remote inspection program was operating properly.

Given that FINRA intends to allow virtually all firms conduct up to all of their inspections remotely, coupled with an absence of assurances that FINRA will monitor firm compliance, it should be incumbent upon FINRA to build the case for these changes before being allowed to make them across industry for a period of three years. Rather than allowing FINRA and firms to have the relief sought and hoping that they will build a record to support a change in regulations, it would be more prudent to require FINRA to build and publicize a record now, and to propose regulatory relief based on the findings it develops and that third parties can test and verify.

b. State Regulators Believe That a Meaningful Portion of In-Person Inspections Is Necessary to Catch Misconduct that Technological Means Cannot.

State regulators have observed a wide variety of regulatory violations and fraudulent misconduct found in physical inspections of branch offices that we believe would not be captured in remote inspections. Over the past few months, NASAA staff have queried NASAA member inspection staff across the country to learn more about the types of violations observed during in-person inspections that would not be found by technological means. NASAA then shared those observations with staff from the SEC’s Division of Trading and Markets. Examples of misconduct cover a whole range from the innocuous to the criminal, including:

- A state regulator discovered that an associated person hid from the firm a loan from a client to the associated person.²⁴
- A state regulator found fake account statements used to conceal a Ponzi scheme.
- A state regulator found that an associated person forged a document by cutting and pasting a customer signature onto a form. The same regulator found, in another

²⁴ FINRA has found similar misconduct. *See, e.g.*, Letter of Acceptance, Waiver and Consent No. 2021070774101, *David John Wilkie* (FINRA, Aug. 2, 2022) (finding that representative failed to disclose to his firm that he had become a beneficiary on a customer’s insurance policy, and that from 2012-2020, the representative denied it on the firm’s annual compliance questionnaire and took further steps to conceal it from the firm).

inspection, that an associated person had asked a customer to pre-sign blank forms for future use.

- State regulators have found undisclosed outside business activities and related companies when conducting in-person inspections, as well as unregistered persons conducting business in remote branch locations.
- State regulators have overheard sales pitches for securities not approved by the firm.
- State inspectors have found unsecured checks and client documents at remote locations, as well as an instance in which an associated person directed client mail to a home address rather than a firm address.
- State regulators have found unsecured laptops in violation of firm policies.
- State regulators have also found physical objects during in-person inspections that are unlikely to be captured through technological monitoring, such as fake degrees, dated customer service awards, and stale sales literature.
- A state regulator found an associated person whose diminished capacity was being compensated for and hidden by sales assistants.

To be fair, in discussions with NASAA members, industry representatives have described procedures by which they will direct an associated person to walk through his or her home office with a camera so they can view the work area. However, state regulators are not convinced that these walkthroughs are generally effective, especially with respect to people who are actively concealing misconduct. In-person inspections often turn up evidence of misconduct in far flung areas of an office, or in closed drawers. They 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 level of candor of their associated persons in ways that are harder to detect on the phone or during a videoconference. The Pilot Program Proposal would excuse FINRA member firms from even considering such visits unless and until some undefined signal in electronic surveillance alerts the firm to dig deeper.

Part of the reason that FINRA is making the Proposals is that some of its members are clamoring for relief because they have allowed their workforces to disperse, and they are not ready to begin inspecting them physically again. If FINRA member firms are allowed to continue these practices for another three years with no prescriptive requirements, and no assurance of close monitoring, it will be even more difficult to impose discipline on them once problems become apparent. If lax remote inspection practices become the norm, it will take years of examinations and enforcement actions to bring them back up to an acceptable level. The SEC can avoid that outcome now by taking a step back, extending temporary relief for a brief period, and requiring FINRA to build the record necessary to assess and then offer evidence-based proposals.

c. The Pilot Program Proposal Would Force Regulators to Fill Gaps Created by Lax Firm Inspection Practices.

All regulators, including the SEC, FINRA and state regulators, are constrained by resource limitations. As things stand, regulators already make difficult decisions about the number of examinations they can conduct. Most regulators would prefer more extensive coverage over their regulated populations than they can provide. In other words, regulators try to do as much as they can in an effort to stem the worst misconduct out there. To know that frauds and lesser harms could be mitigated through more examinations is an uncomfortable reality for all regulators. The Pilot Program Proposal would impose additional and unplanned burdens on all regulators.

The Pilot Program Proposal would make the dilemma of regulators worse by easing inspection burdens on firms. However, regulators cannot stand by and hope that firms will do a good job of remote surveillance. Further, if regulators find rising instances of remote misconduct, they will have to act, but they will be forced to do so against a three-year grant of leniency that will make compliance difficult. It will also make enforcement difficult because firms will be able to argue that their lackluster remote surveillance policies and procedures accord with the pilot program's requirements. The Pilot Program Proposal says nothing about the increased burden it will place on regulators, especially state regulators, who are already stretched to capacity.

III. Comments on the Supervisory Location Proposal

The SEC should not approve the Supervisory Location Proposal because FINRA has not explained adequately why the frequency of inspections of supervisory offices should be reduced. As with the Pilot Program Proposal, FINRA's argument hinges on simple references to such things as "significant technology and industry changes" and "the significant advance of technological tools that are now readily available."²⁵ However, like the Pilot Program Proposal FINRA does not detail which purported technological advances support lessening the frequency of supervisory office inspections, and it offers no data other than anecdotal industry claims to assure the SEC that such technologies are being implemented widely and effectively among member firms. On the other hand, the SEC is finding that the misuse of technological advances by supervisors is prevalent. There is no correlation between technological advances and effective compliance.

On the contrary, the appropriate frequency of inspections of supervisory offices should be based on the importance of supervisory functions to a firm's ability to comply with the law. In that light, nothing has changed; supervisory functions are just as critical as they have always been. If anything, they are becoming more critical and more challenging as firms allow their workforces to disperse, and supervisors have less direct contact with their supervised persons. Firms must ensure that supervisors can do their jobs effectively in dispersed environments, and the frequency of inspections of supervisory offices should be commensurate with that challenge. The Supervisory Location Proposal does not link the frequency of inspections to supervisors' growing challenges. Instead, it regards technology as an assumed panacea.

²⁵ Supervisory Location Proposal at 7 and 16.

Further, if it is a given that industry is migrating to remote surveillance, it is also true that supervisors will need to learn new skills. The Supervisory Location Proposal recognizes that inexperienced supervisors should not be able to operate from residential locations,²⁶ but it does not make the case that more experienced supervisors are generally adept enough at remote surveillance technologies to supervise effectively. This is crucial because FINRA envisions a future in which the frequency of on-site supervision would become risk-based.²⁷ If a supervisor cannot use technology to identify red flags effectively, then the whole paradigm that industry is promoting will fail. In short, supervisory offices should be visited with the same frequency as before because the importance of their work has not changed, and because firms need to understand how well supervisors are adapting to technological surveillance methods.

Once a record of effective remote supervision has been established such that the SEC would feel confident to allow less frequent inspections of supervisory offices, FINRA could then seek approval of the Supervisory Location Proposal. However, NASAA also suggests that FINRA should make at least the following three changes.

First, proposed Supplementary Material .19(a)(7) should be revised to state that *“all correspondence and communications by the associated person related in any way to existing or potential business activities are subject to the firm’s supervision in accordance with this Rule.”* NASAA suggests this change because the existing reference to “the public” is not clear. The correspondence and communications subject to firm supervision would be better defined by subject, not recipient.

Second, proposed Supplementary Material .19(a)(10) should be revised (in bold) to state that *“all books or records required to be made and preserved by the member under the federal securities laws or FINRA rules **are created on the member’s electronic systems, and are maintained on the member’s electronic or other central recordkeeping systems.**”* The current language, which states only that the books and records should be retained somewhere “other than at the location” could leave the supervisory office free to maintain records outside of the firm’s central control. Also, requiring documents to be created on firm systems would address instances described above in which state regulators have found forged and pre-signed physical documents.

Third, proposed Supplementary Material .19(b)(9) should be revised (in bold) to state that *“one or more associated persons at such location is currently subject to, or has been notified in writing that it will be subject to, any investigation, proceeding, complaint or other action by the member, the SEC, a self-regulatory organization, including FINRA, or state securities commission (or agency or office performing like functions) alleging they have failed reasonably to supervise another person subject to their supervision, with a view to preventing the violation of any provision of the Securities Act, the Exchange Act, the Investment Advisers Act, the Investment Company Act, the Commodity Exchange Act, **any state law pertaining to the regulation of securities,** or any rule or regulation under any of such **acts or laws,** or any of the rule s of the MSRB.”* The Supervisory

²⁶ See *id.* at 4, proposed Supplementary Material .19(b)(4).

²⁷ See Pilot Program Proposal at 16.

J. Matthew DeLesDernier

August 23, 2022

Page 13 of 13

Location Proposal recognizes that a state investigation, proceeding, complaint or other action is a sufficient reason to make the location ineligible, but the language limits the scope to alleged violations of the federal securities laws or self-regulatory rules. State regulators investigate and bring actions for violations of state securities laws, and the provision should reflect that within its scope.

IV. Conclusion

NASAA requests that the SEC reject the Proposals and ask FINRA to build a record sufficient to justify the extraordinary changes it is proposing. The danger to investors from a wide scale relaxation of in-person supervision is too great to test on the fly. While the pandemic forced temporary changes on all of us, it did not change the fact that certain persons are prone to misconduct, and it cannot be assumed that the manner in which firms were forced to operate during the pandemic is acceptable going forward. The effectiveness of remote supervision must be evidence-based. Should you have questions, please contact either the undersigned or NASAA's General Counsel, Vince Martinez, at [REDACTED].

Sincerely,



Melanie Senter Lubin
NASAA President and
Maryland Securities Commissioner

Exhibit A

Vince Martinez

From: Vince Martinez
Sent: Friday, October 29, 2021 10:46 AM
To: Dean, Gregory; Kosha.Dalal@finra.org; Richard.Pullano@finra.org; Paul.Rothstein@finra.org; Patricia.LedesmaLiebana@finra.org; Kyle.Innes@finra.org
Cc: Pam Epting
Subject: Questions for Branch Office Survey

FINRA Colleagues:

Below please find questions that we request be added to your survey on remote inspection practices and remote work arrangements. Please let us know if you have any questions. Thank you very much.

Vince

General:

- Do you allow recently hired representatives to work remotely?
- Do you have a set timeframe for recently hired representatives to be allowed to work remotely (i.e., are recently hired representatives required to work in physical offices for a period of time)?
- Do you have remote inspection requirements tailored to recently hired representatives?
- Does your firm currently have sufficient physical offices operating to accommodate newly hired representatives?
- Are all employees required to attend training specific to remote working?
- What additional documents or information do you request when inspecting a branch located in or affiliated with a third party?
- Do you speak with third parties when inspecting a branch located inside or affiliated with the third party (e.g., a financial institution, etc.)?

Policies and Procedures:

- Do you have written policies and procedures for remote branch inspections?
- Have you revised your policies and procedures since March 2020 regarding branch inspections to account for remote inspections?

- When was the last time you revised your policies and procedures for inspections?
- Do you conduct audits to determine whether your policies and procedures for all inspections are effective?
- Do you conduct audits to determine whether your policies and procedures for remote inspections are effective?
- Do you conduct in-person inspections of any branch following a remote inspection?
- Do you conduct a mixture of in-person and remote inspections?
- Have you found instances in which your policies and procedures for remote inspections needed to be amended because they did not capture violations of firm policy or misconduct?
- What percentage of personnel working remotely have you inspected in the last year?
 - How many inspections fall into this category? [THIS ALTERNATIVE IS MEANT TO CAPTURE SITUATIONS IN WHICH A PERCENTAGE FIGURE WOULD BE MISLEADING.]
- What percentage of personnel working in physical offices have you inspected in the last year?
 - How many inspections fall into this category?
- What percentage of remote inspections yielded a deficiency within the last year?
 - How many inspections fall into this category?
- What percentage of in-person inspections yielded a deficiency within the last year?
 - How many inspections fall into this category?
- What percentage of all inspections yielded a deficiency within the last year?
 - How many inspections fall into this category?
- What percentage of all inspections yielded a deficiency in 2019?
 - How many inspections fall into this category?
- What percentage of all inspections yielded a deficiency in the 12 months from March 2019 through March 2020?
 - How many inspections fall into this category?
- Do you use a third party to conduct audits of your policies and procedures?
- Do you use a third party to conduct audits of your remote inspection procedures?

- Has any consultancy made a recommendation that you improve your policies and procedures for remote inspections?
- Did any regulator or self-regulatory organization find any deficiencies in your policies and procedures for inspections in the last year?
- Did any regulator or self-regulatory organization find any deficiencies in your policies and procedures for inspections in 2019?
- Did any regulator or self-regulatory organization find any deficiencies in your policies and procedures for inspections in the 12 months from March 2019 to March 2020?

Outside Business Activities:

- How do you inspect for outside business activities remotely? [THIS COULD BE A MULTIPLE CHOICE QUESTION.]
- Are you able to apply all outside business activity monitoring measures that you use during in-person inspections to remote inspections?
- Do you require representatives to conduct all business communications on firm equipment?

DBAs:

- Has your firm found any undisclosed/unauthorized DBAs since March 2020.
- How do you inspect for usage of representatives or firms using a DBA? [THIS COULD BE A MULTIPLE CHOICE QUESTION.]
- Do you require firms or representatives to provide additional documents for review when using a DBA?
- Do you interview customers when a firm or representative uses a DBA?
- Are you able to apply all DBA monitoring measures that you use during in-person inspections to remote inspections?

Regulation S-P and Cybersecurity:

- Do you test the cybersecurity of representatives' remote locations?
- Do you test the cybersecurity of representatives' equipment?
- Do you prevent representatives from printing firm information at remote locations?
- Do you monitor representatives' printing activities?
- Do you allow representatives to conduct firm business with personal equipment?
- Are representatives able to copy information from firm systems to personal devices or data storage?

- Do you inspect representatives' residences to determine if persons with histories of criminal or regulatory violations have access to firm information?
- Do you prevent representatives from working in locations occupied by persons with histories of criminal or regulatory violations?
- Do you require representatives to use multi-factor authentication when logging into firm systems from remote locations?
- Do you monitor representatives' emails to addresses not associated with the firm or client accounts?

Heightened Supervision:

- Do you allow representatives under heightened supervision to work remotely?
- Do you have remote inspection requirements tailored to persons under heightened supervision?
- Has your firm required representatives under heightened supervision to return to physical locations within the last year?
- Does your firm intend to require persons under heightened supervision to return to physical offices?
- Does your firm intend to terminate persons under heightened supervision who are unable or refuse to return to physical offices?
- Does your firm currently have sufficient physical offices operating to accommodate all representatives under heightened supervision?