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VIA ELECTRONIC DELIVERY

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: **Amendment No. 1 to Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision); File No. SR-FINRA-2022-021; Release No. 34-96520**

Dear Ms. Countryman:

Two Sigma Securities, LLC (“TSS” or the “Firm”)¹ respectfully submits this letter in response to the above-referenced Amendment No. 1 to Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision) (the “Proposed Amendment”),² filed by the Financial Industry Regulatory Authority Inc. (“FINRA”) with the Securities and Exchange Commission (the “SEC” or the “Commission”) on December 16, 2022.

¹ TSS is a registered market maker focused on providing liquidity through systematic trading strategies across asset classes, which are offered through three core business activities: (1) Market Making and Intraday Alpha; (2) Options Market Making; and (3) Client Trading via our wholesale market making, algorithmic trading services, and single dealer platform offerings. The vast majority of trading activity conducted by these business units is fully automated with minimal human intervention. All orders are received via electronic methods and supervision of such activity is done via electronic tools and reports.
² See File No. SR-FINRA-2022-021; Release No. 34-96520, Amendment No. 1 to Proposed Rule Change, available at <https://www.finra.org/rules-guidance/rule-filings/sr-finra-2022-021>.

The Proposed Amendment was issued to address comments received in response to FINRA’s proposed Supplementary Material .18 to Rule 3110 (the “Proposed Rule”).³ The Proposed Rule seeks to establish a three-year trial period during which firms would be allowed to meet their Rule 3110(c) obligations by conducting inspections remotely.⁴ If approved, the Proposed Rule would replace temporary Rule 3110.17, which has permitted firms to conduct Rule 3110(c) inspections remotely since November 2020.⁵ In explaining the rationale behind the Proposed Rule, FINRA notes the significant and widespread technological advances that have been made in the ways that member firms conduct their business and facilitate communication by and amongst their associated persons, and the related technological advances in the ways that firms supervise those activities.⁶ FINRA also notes that the use, scope, and efficacy of the technologies employed by firms to conduct and supervise their business activities increased during the COVID-19 pandemic, and contributed to the need for FINRA to consider modernizing its rules.⁷

FINRA issued the Proposed Amendment on December 16, 2022 to address concerns regarding the scope of the proposal’s controls and its exclusions for higher risk conduct, among other things. Specifically, the Proposed Amendment states: “In light of the comment letters, with this Partial Amendment No. 1, FINRA is proposing to amend [the Proposed Rule] to:

³ See File No. SR-FINRA-2022-021; Release No. 34-96520, Text of the Proposed Rule Change, available at <https://www.finra.org/rules-guidance/rule-filings/sr-finra-2022-021>.

⁴ FINRA Rule 3110(c) establishes the location inspection requirements with which member firms must comply.

⁵ See Proposed Rule at 7.

⁶ See Proposed Rule at 4 (“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.”).

⁷ See Proposed Rule at 6 (“[i]nsights 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) obligations, should be modernized. Technological improvements and developments in regulatory compliance have provided more tools than before to create more effective and efficient compliance programs.”).

- (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 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 a member fails to comply with the requirements of Rule 3110.18.”⁸

Under the Proposed Amendment, FINRA would exclude from eligibility for remote inspections “an office or location at which . . . (vi) one or more associated persons at such office location *is 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)”.⁹

The Firm supports FINRA’s continued efforts to modernize its rules and agrees with many of the considerations FINRA outlined in explaining the rationale behind the Proposed Rule and Proposed Amendment. However, the above-referenced exclusion – hereafter, the “Trading Desk Exclusion” – (1) is overly broad and unduly burdensome; and (2) overstates the risk presented by trade desk personnel and runs counter to achieving FINRA’s stated aims. For the foregoing reasons, the Firm respectfully opposes the addition of the Trading Desk Exclusion to the Proposed Rule as amended.

⁸ Proposed Amendment at 4.

⁹ *Id.* at 9.

Overview of Existing & Proposed Rules

Temporary Rule 3110.17

When the COVID-19 pandemic forced firms to have their associated persons work from their private residences, each of those locations effectively became a location of the firm. In one fell swoop, firms that may have had a handful of locations before the pandemic, suddenly had as many locations as associated persons. As a result, though the precise classification of each location may have varied based on the associated person working there and the nature of the business conducted, each such location would have to be inspected under Rule 3110(c). In response to the “operational challenges” presented by the prospect of having member firms conduct on-site inspections of all these new locations during the pandemic, FINRA adopted temporary Rule 3110.17, which allowed firms to conduct remote inspections of their locations, subject to certain conditions.¹⁰

Under Rule 3110.17, which has been extended through the end of 2023, or the effective date of the Proposed Rule, whichever is sooner, firms remained subject to the requirements of Rule 3110(c) and Rule 3110.12. Firms were also required to update their written supervisory procedures (“WSPs”) to include reasonably designed procedures for conducting remote inspections, including, among other things, “(1) a description of the methodology, including technologies permitted by the member, that may be used to conduct remote inspections; and (2) the use of other risk-based systems employed generally by the 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.”¹¹

Related Proposed Rules

In addition to the Proposed Rule and Proposed Amendment discussed above, FINRA has sought to implement other rule updates in recognition of the shift to hybrid and fully remote working arrangements that are now commonplace in the industry. Notable among those

¹⁰ See Proposed Rule at 7. See also Rule 3110.17 (“Temporary Relief to Allow Remote Inspections for Calendar Years 2020, 2021, 2022, and 2023.”).

¹¹ See Rule 3110.17(b).

proposals is the Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) (the “RSL Proposal”).¹² In a letter responding to comments received on the RSL Proposal, FINRA makes clear that the proposal, if approved, will not apply to locations where firms engage in order execution and market making – activities typically conducted by trading desk personnel. This means that firms that permit associated persons engaged in order execution or market making to work from home – a practice that has become common industry-wide – will be required to conduct Rule 3110(c) inspections of those persons’ homes annually.

FINRA’s proposed regulatory structure – including the existing rules, proposed rules and amendments, and related comments and guidance – combined with the “permanent shift to a remote or hybrid work environment”¹³ will likely create a scenario in which member firms are required to conduct and document in-person inspections of the homes of their trading desk personnel on an annual basis. As noted above, TSS views that potential outcome as overly broad, unduly burdensome, and unnecessary for firms to meet their supervisory responsibilities with respect to their trading desk employees.

Discussion

1. The Trading Desk Exclusion is overly broad and unduly burdensome.

Unlike the other exclusions in the Proposed Amendment that focus on specific activities (e.g., handling customer funds or securities) or on the existence of specific circumstances (e.g., disciplinary action taken by the firm), the Trading Desk Exclusion focuses on a broad category of people with little regard for their actual day-to-day job functions. The exclusion refers to locations where “one or more associated persons at such office or location is a part of the member’s trading desk[.]”¹⁴ Trading desks are comprised of people who perform a variety of functions based on the nature of the firm and the trading desk itself. By focusing

¹² See File No. SR-FINRA-2022-019; Release No. 34-95379, available at <https://www.finra.org/rules-guidance/rule-filings/sr-finra-2022-019>. The RSL Proposal seeks to treat a member’s residential locations that supervise other locations, which would otherwise be considered OSJs or supervisory branch offices, as non-branch locations.

¹³ Proposed Rule at 49.

¹⁴ Proposed Amendment at 9.

on any person affiliated with a trading desk, the exclusion will likely sweep in individuals whose job functions do not include entering trades, committing firm or customer capital, or any of the other activities historically viewed as requiring in-person inspection. FINRA does not explain the breadth of the exclusion beyond offering the general conclusion that “the functions of a member’s trading desk . . . are significant activities potentially impacting the operations and financial stability of the firm and, as a result, may also significantly impact customers and the markets generally.”¹⁵ But, not only does this not explain why any trading desk affiliate, regardless of their actual job functions, should be excluded, it also doesn’t explain why trade desk employees, especially those who exclusively use electronically monitored systems, are in any greater need of on-site inspection. Indeed, further evidence of the overbreadth of the Proposed Amendment is its failure to distinguish between trading personal who exclusively use electronically monitored systems and those that use voice or other mechanisms that are not subject to similarly rigorous scrutiny. The Proposed Amendment would exclude people based on their affiliation with a trading desk despite their actual job functions presenting no greater risk than the activities of other associated persons the Proposed Rule purports to cover. As such, it is overly broad.

On-site inspections are costly and time-consuming for firms, particularly firms with limited resources. The travel and other logistical efforts required to conduct on-site inspections can place a significant burden on firms and their employees. With associated persons – including trading desk personnel – of many member firms now able to perform their work responsibilities from home pursuant to a hybrid work arrangement, firms are required to inspect those residential locations. Now that the locations to be inspected include employees’ homes, the burden associated with conducting on-site inspections will likely significantly increase. Though technology has made it possible for associated persons to work from their homes as they would in a traditional office location, there remain significant differences between homes and traditional office locations that should be accounted for when considering on-site inspections.

Notably, traditional office locations are chosen in part for their accessibility. They are generally located in places that are convenient to get to and that can be accessed by several

¹⁵ *Id.*

different means. Residential locations, on the other hand, are often chosen with different considerations in mind, privacy among them, and may, therefore, be further off the beaten path, and offer fewer means of access, than traditional offices, thus increasing the burden on firms to inspect them. Similarly worthy of consideration on this issue is the significant increase in the number of locations firms will be required to inspect. As an example, a firm with thirty trading desk employees working on a hybrid basis – a relatively modest number – would be required to inspect the homes of all thirty employees in person. What’s more, given FINRA’s comments regarding the RSL Proposal, to the extent that the thirty trading desk employees are involved in order execution or market making, the firm would be required to inspect their homes annually. A firm like the one described might have gone from having one or two locations to inspect to having thirty, a significant increase in the burden of conducting these inspections, and one that FINRA does not appear to have considered. The Proposed Amendment includes no cost-benefit analysis or other discussion that addresses the time and money that compliance with the Proposed Amendment will cost member firms. As discussed further below, the undue nature of the burden and cost is compounded by the fact that modern-day electronic trading presents the sorts of risks that are easily addressed through electronic surveillance and supervision mechanisms. The result, therefore, is a rule that creates substantial burden without a corresponding benefit.

2. *The Trading Desk Exclusion overstates the risk presented by trade desk personnel and runs counter to achieving FINRA’s stated aims.*

With the addition of the Trading Desk Exclusion, FINRA has effectively put the locations where trade desk personnel work in the same risk category as those with associated persons who are subject to disciplinary action reportable under Rule 4530(a)(2) and those with associated persons who handle customer funds or securities.¹⁶ FINRA explains that such locations “may particularly benefit from in-person inspections . . . regardless of [a firm’s] risk assessment.”¹⁷ FINRA offers an explanation for the exclusion of locations with disciplined employees and locations where customer funds are handled, but offers no such

¹⁶ See Proposed Amendment at 9.

¹⁷ *Id.*

justification for the exclusion of locations with trading desk personnel.¹⁸ On the contrary, throughout its discussion of the Proposed Rule and Proposed Amendment, FINRA points to the technological advancements – including those in the “processes for . . . placing trades” – that have eroded the “original bases for an on-site inspection requirement.”¹⁹

Like many member firms, the sorts of technological advancements FINRA references in the Proposed Rule have been incorporated into TSS’ business activities. The Firm uses fully electronic communication systems and record keeping methods to support its trading activities. Every step of the Firm’s trading process is electronically logged and monitored throughout the trading day and the trading activities and communications of the Firm’s employees are subject to constant centralized electronic surveillance and supervision, regardless of their location. Every order entered via the Firm’s system is immediately visible to everyone on the desk and subject to the Firm’s controls and even employee personal trading is subject to the Firm’s electronic oversight as required under FINRA rules. The existence of these technological tools has significantly reduced the risks historically associated with trading activities, effectively erasing the kinds of risks that on-site inspections were intended to address. Robust technological infrastructure enabled the Firm to transition to remote operations – including remote inspections in accordance with temporary Rule 3110.17 – during the pandemic and will allow the Firm to continue doing so going forward.

The viability of electronic supervision combined with remote location inspections is not merely theoretical. At the onset of the Covid-19 pandemic, firms industry-wide required their employees – including trading desk personnel – to work remotely from their private residences. Temporary Rule 3110.17 came into effect in November 2020 and firms have spent the years since conducting remote inspections of all their locations. In other words, the locations the Proposed Amendment would exclude are the same locations firms have been inspecting remotely under 3110.17 since November 2020. Despite more than two years of firms remotely inspecting locations that FINRA now seeks to carve out as especially risky, FINRA has not identified any increase in rule violations or the like that resulted from permitting remote inspection of trade desk employees. On the contrary,

¹⁸ *Id.*

¹⁹ *See* Proposed Rule at 4.

FINRA has tacitly acknowledged the efficacy of remote inspections as it has continued to conduct examinations of its member firms remotely, even though hybrid work arrangements now allow for on-site visits to be resumed.

Given the use of technological tools to both conduct and supervise trading, and the demonstrated effectiveness of remote inspections under temporary Rule 3110.17, the Trading Desk Exclusion reflects an overestimation of the risks presented by today's trading desk personnel and an underestimation of the ability of firms to effectively supervise the activities of trading desk personnel by means other than on-site inspections.

* * *

For the foregoing reasons, we believe the Trading Desk Exclusion is both overly broad and unduly burdensome and overestimates the risks associated with the electronic trading methods that have become commonplace in today's industry. The fact that FINRA issued temporary Rule 3110.17 and is now following with the Proposed Rule, is an acknowledgment of the need to address the logistical challenges and other burdens associated with performing on-site inspections now that hybrid and remote work are here to stay. However, the Trading Desk Exclusion is so broad that it severely undercuts the purpose of the Proposed Rule in the first place. FINRA does not appear to have adequately considered the additional burdens and costs that firms will be required to bear because of the Trading Desk Exclusion, and we would ask FINRA to do so before finalizing this Proposed Rule.

The Firm recognizes and appreciates FINRA's efforts to bring its rules into alignment with the current environment in the securities industry. We are grateful for the opportunity to comment on the Proposed Rule.

Sincerely,

Sandip Khosla

Sandip Khosla
General Counsel