

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-95452; File No. SR-FINRA-2022-021)

August 9, 2022

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on July 28, 2022, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

FINRA is proposing to amend FINRA Rule 3110 (Supervision) to adopt a voluntary, three-year remote inspection pilot program to allow member firms to elect to fulfill their obligation under Rule 3110(c) (Internal Inspections) by conducting inspections of some or all branch offices and locations remotely without an on-site visit to such office or location, subject to specified terms.

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

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

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

1. Purpose

Beginning many years ago, SEC staff and FINRA have interpreted FINRA rules to require member firms to conduct on-site inspections of branch offices and unregistered offices (*i.e.*, non-branch locations) in accordance with the periodic schedule described under Rule 3110(c)(1).³ Over the years, widespread advancements in technology and communications in the financial industry have significantly changed the way in which members and their associated persons conduct their business and communicate, including the practices that formed the original bases for an on-site inspection requirement. For

³ See SEC National Examination Risk Alert, Volume I, Issue 2 (November 30, 2011), <https://www.sec.gov/about/offices/ocie/riskalert-bdbranchinspections.pdf> and Regulatory Notice 11-54 (November 2011) (“Notice 11-54”) (joint SEC and FINRA guidance stating, a “broker-dealer must conduct on-site inspections of each of its office locations; [Office of Supervisory Jurisdiction (“OSJs”)] and non-OSJ branches that supervise non-branch locations at least annually, all non-supervising branch offices at least every three years; and non-branch offices periodically.”). See also SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (“SLB 17”) (stating, in part, that broker-dealers that conduct business through geographically dispersed offices have not adequately discharged their supervisory obligations where there are no on-site routine or “for cause” inspections of those offices), <https://www.sec.gov/interps/legal/mrslb17.htm>.

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

FINRA notes that firms are turning to new and innovative regulatory tools such as artificial intelligence, natural language processing, and robotics process automation, among others, to strengthen their compliance programs.⁴ More recently, firms have questioned the benefits of the on-site inspection requirement for all offices, particularly in light of these significant technological advances that have enhanced the effectiveness of a

⁴ See generally 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.

firm’s overall and ongoing supervision and monitoring of the activities occurring at their offices (registered and unregistered).⁵

The COVID-19 pandemic has accelerated the use of a wide variety of compliance and workplace technology as many government and private employers, including member firms, were driven to adopt a broad remote work environment by quickly moving their employees out of their usual office setting to an alternative worksite such as a private residence. Insights obtained from member firms and other industry representatives through various pandemic-related initiatives and other industry outreach have led FINRA to carefully consider whether some processes and rules, including the manner in which a firm may satisfy its Rule 3110(c) obligations, should be modernized.⁶

⁵ Some firms have indicated, for example, that technology has enhanced real time monitoring of their associated persons by providing the ability for firm compliance personnel to join, on an ad hoc basis, digital or virtual meetings occurring between the firm’s associated persons and customers. Firms have also indicated that technology has allowed them to impose various restrictions or limitations on associated persons, such as the ability to print firm records from remote locations using a firm-issued laptop, and only accepting electronic payments from customers.

⁶ See generally FINRA’s Key Topic: COVID-19/Coronavirus (referencing, among other things, Frequency Asked Questions, temporary amendments to FINRA rules, and Regulatory Notices such as Regulatory Notices 20-08 (March 2020) (“Notice 20-08”), regarding pandemic-related business continuity planning, guidance and regulatory relief to member firms from some requirements, including the temporary suspension of the requirement to maintain updated information on Form U4 (Uniform Application for Securities Industry Registration or Transfer) and submit Form BR (Uniform Branch Office Registration Form) for temporary locations; 20-16 (May 2020) (“Notice 20-16”), describing practices implemented by firms to transition to, and supervise in, remote work environment during the COVID-19 pandemic; 20-42 (December 2020) (“Notice 20-42”), seeking comment on lessons from the pandemic; and 21-44 (December 2021) (“Notice 21-44”), regarding business continuity planning and lessons from the pandemic, <https://www.finra.org/rules-guidance/key-topics/covid-19>. See also SEC Press Release 2022-112 (June 22, 2022) for the Spring 2022 Regulatory Agenda (quoting SEC Chair Gary Gensler: “When I think about the SEC’s agenda, I’m driven by two public policy goals: continuing

Technological improvements and developments in regulatory compliance have provided more tools than before to create more effective and efficient compliance programs. To that end, FINRA believes that regulatory models should evolve to benefit from the availability and use of effective technology tools. With the confluence of advances in compliance technology and the permanent shift to a remote or hybrid work environment, made more pronounced by the pandemic, FINRA believes that the optimal use of on-site inspections deserves further consideration.

To address the operational challenges in conducting on-site inspections during the pandemic, FINRA adopted temporary Rule 3110.17, effective since November 2020, to provide member firms the option to conduct inspections of their branch offices and non-branch locations remotely, subject to specified terms therein.⁷ Although uncertainty about the pandemic remains, firms are beginning to look ahead at the post-pandemic changes to their workplaces, including more flexible work hours and hybrid work models—working sometimes on-site in a conventional office setting and other times remotely in a private residence or other alternative worksite. As such, FINRA believes now is the time to assess possible longer-term rule changes and is, therefore, proposing a voluntary, three-year remote inspections pilot program. This program would provide FINRA with specific, structured data from member firm pilot participants to evaluate their experiences—positive and negative—and inspection findings. This data would

to drive efficiency in our capital markets and modernizing our rules for today's economy and technologies.”), https://www.sec.gov/news/press-release/2022-112?utm_medium=email&utm_source=govdelivery.

⁷ See Securities Exchange Act Release No. 90454 (November 18, 2020), 85 FR 75097 (November 24, 2020) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-040).

enable FINRA to systematically assess the overall impact on firms' supervisory systems, which has not been feasible with information drawn from the pandemic-related office shutdowns. Moreover, the proposed pilot program would maintain effective supervision by firms through firms' ongoing supervisory obligations under Rule 3110, and the proposed limitations on the firms and locations that would be eligible to participate in the proposed pilot program.

The Inspection Requirement Under Rule 3110

The responsibility of firms to supervise their associated persons is a critical component of broker-dealer regulation.⁸ Member firms must supervise all of their associated persons, regardless of their location, compensation or employment arrangement, or registration status.⁹ Rule 3110 requires a member, regardless of size or type, to have a supervisory system for the activities of its associated persons that is

⁸ See SLB 17, *supra* note 3; see also Notice 11-54 and Notice to Members 98-38 (May 1998) (“Notice 98-38”).

⁹ This obligation is derived from Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act. Section 15(b)(4)(E) provides that the “Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds . . . that such broker or dealer . . . or any person associated with such broker or dealer . . . has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.” 15 U.S.C. 78o(b)(4)(E). Section 15(b)(6)(A)(i) parallels Section 15(b)(4)(E) and provides for the imposition of sanctions against persons associated with a broker or dealer that violates those statutes, rules and regulations enumerated in Section 15(b)(4)(E) and other specified subparagraphs under Section 15(b)(4). 15 U.S.C. 78o(b)(6)(A).

reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules, and sets forth the minimum requirements for such supervisory system.¹⁰

As part of that supervisory system, Rule 3110(c) requires a member to review, at least annually, the businesses in which it engages for purposes of detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations. The review must include periodic inspections of each office and examination of customer accounts to detect and prevent irregularities and abuses. The inspection requirement is a longstanding supervisory obligation that in its early form had addressed the inspection requirement for an OSJ only.¹¹ FINRA expanded the inspection requirement to cover branch offices out of concern for the potential regulatory problems that could emerge when a registered person, situated in an office other than an OSJ, was engaging in securities-related activities without the direct oversight of qualified supervisory personnel and without an annual inspection.¹²

¹⁰ See Rule 3110(a).

¹¹ Article III, Section 27(d) of the NASD Rules of Fair Practice had provided: “Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction.” See Notice to Members 87-41 (June 1987) (setting forth the then existing rule text for specified parts of Article III, Section 27 (Supervision) of the NASD Rules of Fair Practice as part of a proposal to amend the OSJ and branch office definitions).

¹² See Securities Exchange Act Release No. 26177 (October 13, 1988), 53 FR 41008 (October 19, 1988) (Order Approving File No. SR-NASD-88-31). See also Notice to Members 88-84 (November 1988) and Notice to Members 89-34 (April 1989).

Currently, Rule 3110(c) sets forth three main requirements for conducting internal inspections. First, an inspection of an office or location must occur on a designated frequency. The periodicity of the required inspection varies depending on the classification of the location or the nature of the activities that take place: OSJs and supervisory branch offices must be inspected at least annually;¹³ non-supervisory branch offices, at least every three years;¹⁴ and non-branch locations, on a periodic schedule, presumed to be at least every three years.¹⁵ Second, a member must retain a written record of the date upon which each review and inspection occurred, reduce a location's inspection to a written report and keep each inspection report on file either for a minimum of three years or, if the location's inspection schedule is longer than three years, until the next inspection report has been written.¹⁶ If applicable to the location being inspected, the inspection report must include the testing and verification of the member's policies and procedures, including supervisory policies and procedures, in specified areas.¹⁷ Third, to prevent compromising the effectiveness of inspections due to

¹³ See Rule 3110(c)(1)(A).

¹⁴ See Rule 3110(c)(1)(B).

¹⁵ See Rules 3110(c)(1)(C) and 3110.13 (General Presumption of Three-Year Limit for Periodic Inspection Schedules).

¹⁶ See Rule 3110(c)(2).

¹⁷ See Rule 3110(c)(2)(A) (providing that the inspection report must include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures for: (1) safeguarding of customer funds and securities; (2) maintaining books and records; (3) supervision of supervisory personnel; (4) transmittals of funds from customers to third party accounts, from customer accounts to outside entities, from customer accounts to locations other than a customer's primary residence, and between customers and registered representatives, including the hand delivery of checks; and (5) changes

conflicts of interest, the rule requires a member to ensure that the person conducting the inspection is not an associated person assigned to the location or is not directly or indirectly supervised by, or otherwise reporting to, an associated person assigned to that location.¹⁸ All branch offices and non-branch location are subject to Rule 3110(c).

Further, Rule 3110.12 (Standards for Reasonable Review) sets out factors that constitute a reasonable review. This provision emphasizes establishing reasonable supervisory procedures and conducting reviews of locations, taking into consideration, among other things, the member's size, organizational structure, scope of business activities, number and location of the member's offices, the nature and complexity of the products and services offered by the member, the volume of business done, the number of associated persons assigned to a location, the disciplinary history of registered representatives or associated persons, and any indicators of irregularities or misconduct (i.e., "red flags").¹⁹ The provision further states that the procedures established and

of customer account information, including address and investment objectives changes, and validation of such changes).

¹⁸ Rule 3110(c)(3) provides a limited exception from this requirement if a firm determines compliance is not possible either because of the firm's size or its business model. Rule 3110.14 (Exception to Persons Prohibited from Conducting Inspections) reflects FINRA's expectation that a firm generally will rely on the exception in instances where the firm has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager. However, these situations are non-exclusive, and a firm may still rely on the exception in other instances where it cannot comply because of its size or business model, provided the firm complies with the documentation requirements under the rule.

¹⁹ Red flags that suggest the existence or occurrence of violations, prompting an unannounced visit, may include: customer complaints; a large number of elderly customers; a concentration in highly illiquid or risky investments; an unexplained increase or change in the types of investments or trading concentration that a representative is recommending or trading; an unexpected improvement in a representative's production, lifestyle, or wealth; questionable or frequent transfers

reviews conducted must provide that the quality of supervision at remote (i.e., geographically dispersed) locations is sufficient to ensure compliance with applicable securities laws and regulations and with FINRA rules, and that members must be especially diligent with respect to a non-branch location where a registered representative engages in securities activities. This provision incorporates guidance FINRA has previously issued about supervising associated persons working in geographically dispersed offices.²⁰

In 2004, the SEC staff similarly provided guidance on supervision principles.²¹ At that time, the SEC staff noted that small, geographically scattered offices presented supervisory challenges when they were not subject to on-site supervision. The SEC staff observed that an office's geographic distance from supervisory personnel could make it easier for registered persons and other employees to carry out and conceal violative conduct. This general observation was derived from SEC enforcement cases finding that firms had inadequately supervised their associated persons working in small, geographically distant offices due to the failure of their supervisory mechanisms to detect

of cash or securities between customer or third party accounts, or to or from the representative; a representative that serves as a power of attorney, trustee or in a similar capacity for a customer or has discretionary control over a customer's account(s); representative with disciplinary records; customer investments in one or a few securities or class of securities that is inconsistent with firm policies related to such investments; churning; trading that is inconsistent with customer objectives; numerous trade corrections, extensions, liquidations; or significant switching activity of mutual funds or variable products held for short time periods. See SLB 17, supra note 3; see also Notice 98-38 and Notice to Members 99-45 (June 1999) ("Notice 99-45").

²⁰ See, e.g., Notices 98-38 and 99-45.

²¹ See SLB 17, supra note 3.

and prevent misconduct. Citing technology available at the time, the guidance emphasized that an effective supervisory system for geographically dispersed offices uses a combination of on-site and off-site monitoring; it specifically said that “[c]entralized technology to monitor the trading and handling of funds in remote office accounts, as well as the use of personal computers, helps detect misappropriation of customer funds, selling away, and unauthorized trading, among other things[.]”²² The guidance supported both routine or “for cause” on-site inspections, and encouraged unannounced inspections either on a random basis or where there are red flags about unusual activity at those offices. Further, as noted above, in the past both the SEC staff and FINRA have expressed the view that inspections must have an on-site component, reflecting how office inspections have been historically conducted.²³

Since the time these in-person guidelines were expressed, developments in technology have enhanced firms’ overall and ongoing supervision and monitoring of the activities occurring at branch offices and non-branch locations. In response to these developments, member firms have questioned the historical expectation that firms satisfy the inspection component of Rule 3110(c) solely in a physical, on-site manner.

The 2017 Proposal to Allow Remote Inspections and the Impact from the Pandemic

Even prior to the pandemic, in 2017, FINRA considered a proposal to give firms the option of satisfying the inspection requirement remotely for “qualifying offices” that

²² See SLB 17, supra note 3.

²³ See note 3, supra.

met specified criteria.²⁴ However, the COVID-19 pandemic, declared in early 2020,²⁵ significantly changed the industry's standard business operations, forcing member firms to adapt to a full remote work environment and implement remote supervisory practices.²⁶ FINRA deferred the 2017 Proposal in light of the pressing need to address significant operational disruptions to the securities industry, regulators, impacted member firms, investors and other stakeholders. During this exigent period, FINRA responded to numerous issues and questions that urgently arose.²⁷ Following up on these actions, FINRA published Notice 20-42 to gain a broader understanding of member firm experiences during the pandemic. This notice sought feedback from firms about their experiences in a range of areas, including how member firms' operations and business models changed during the public health crisis and how they might further evolve as the pandemic persisted. Other initiatives included sharing general practices of firms in transitioning and supervising in the remote work environment, and providing temporary

²⁴ See Regulatory Notice 17-38 (November 2017) ("2017 Proposal"). FINRA had requested comment on a proposed amendment to Rule 3110 to allow remote inspections of "qualifying offices" that met specified criteria, in lieu of on-site inspections of such offices and locations. In general, many of the comment letters FINRA had received expressed support for the underlying concept of remote inspections and offered recommendations on specific criteria to broaden the potential population of qualifying offices.

²⁵ See Centers for Disease Control and Prevention ("CDC"), International Classification of Diseases, Tenth Revision, Clinical Modification (ICD-10-CM) (Effective March 18, 2020), <https://www.cdc.gov/nchs/data/icd/Announcement-New-ICD-code-for-coronavirus-3-18-2020.pdf>. See also WHO Director-General, Opening Remarks at the Media Briefing on COVID-19 (March 11, 2020), <https://www.who.int/director-general/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020>.

²⁶ See generally Regulatory Notice 20-16 (May 2020).

²⁷ See note 6, supra.

relief to member firms from specified FINRA rules and requirements.²⁸ In particular, to give firms an opportunity to better manage their operational challenges and redirect resources attendant to fulfilling their inspection obligations, FINRA provided temporary relief to member firms pertaining to the in-person inspection aspect of Rule 3110(c).²⁹

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

At the outset of the pandemic in the United States, many states issued stay-at-home orders and imposed restrictions on businesses, social activities, and travel in hopes of slowing the spread of COVID-19.³⁰ In response, many government and private employers, including member firms, closed their offices and moved their employees to alternative worksites (e.g., an employee's residence). These operational changes made it impracticable for member firms to conduct the on-site inspection component of Rule 3110(c) at most locations for that year because of limitations on travel to geographically dispersed OSJs, branch offices, and non-branch locations. In response to the logistical challenges, FINRA extended the time by which member firms were required to complete their calendar year 2020 inspection obligations under Rule 3110(c) to March 31, 2021 with the expectation that the extension did not relieve firms from the on-site portion of

²⁸ Some temporary amendments to other FINRA rules still remain in effect. See Securities Exchange Act Release No. 95281 (July 14, 2022), 87 FR 43335 (July 20, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2022-018) (extending the expiration date of temporary amendments set forth in SR-FINRA-2020-015 and SR-FINRA-2020-027).

²⁹ See Rules 3110.16 and 3110.17.

³⁰ See note 7, supra, 85 FR 75097, 75098 n.10.

the inspections of their offices and locations.³¹ However, health and safety concerns remained unabated and with many restrictive measures still in place as calendar year 2020 was ending, FINRA adopted Rule 3110.17 to provide member firms the option, subject to specified requirements under the supplementary material, to complete remotely their calendar year inspection obligations without an on-site visit to the office or location.³² This relief was repeatedly extended until the end of 2022.³³ Rule 3110.17 will automatically sunset on December 31, 2022.³⁴

Through comments to the 2017 Proposal, Notice 20-42, the various temporary amendments to Rule 3110, and other engagement with industry representatives, firms have highlighted that Rule 3110(c) was adopted well before the prevalence of modern technology, including laptops, mobile devices, video conferencing capabilities, electronic storage and electronic surveillance, at a time when on-site inspections were the only conceivable way firms could inspect and review activities occurring in outlying offices and locations. The advent of new and developing technologies has enhanced the effectiveness of a firm's ongoing supervision and monitoring of associated persons working from dispersed branch offices and non-branch locations. In addition, firms have

³¹ See Securities Exchange Act Release No. 89188 (June 30, 2020), 85 FR 40713 (July 7, 2020) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-019).

³² See note 7, supra.

³³ See Securities Exchange Act Release No. 93002 (September 15, 2021), 86 FR 52508 (September 21, 2021) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2021-023); and Securities Exchange Act Release No. 94018 (January 20, 2022), 87 FR 4072 (January 26, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2022-001).

³⁴ See note 33, supra.

noted that in practice, those technological advances allow a large portion of inspection work to be conducted electronically, prior to any on-site visit to the office and location, and that in general, on-site inspections of many offices and locations are one component of a firm's overall supervisory system of associated persons and offices, and as such are no longer an efficient and effective use of limited firm resources.³⁵

However, Rule 3110.17 was adopted in the midst of the pandemic, when many offices and locations were closed, and employees carried out their responsibilities from alternative worksites. FINRA recognizes that the pandemic has changed the conventional thinking on where work is conducted and this shift in the workforce landscape will unlikely revert to the model that existed pre-pandemic. As noted above, FINRA believes that adopting a voluntary, three-year remote inspection pilot program, under terms based largely on Rule 3110.17, but with significant safeguards, would allow FINRA the time to collect specified data from member firm pilot participants to evaluate their experiences

³⁵ In response to FINRA's proposed rule changes associated with Rule 3110.17, one commenter made similar points about the physical, on-site piece of the inspection process. This commenter stated that pre-pandemic, an on-site inspection of a branch office typically consisted of reviewing the lobby area of the office, the back office (to review safe contents, sales literature, daily operations logs containing account applications), signage, and the physical security of the office. See Letter from Carrie L. Chelko, Chief Compliance Officer, Fidelity Brokerage Services LLC ("Fidelity Brokerage") & Norman L. Ashkenas, Chief Compliance Officer, National Financial Services LLC ("NFS") and Fidelity Distributors Company LLC ("Fidelity Distributors"), to Vanessa Countryman, Secretary, SEC, dated July 28, 2020, in response to Securities Exchange Act Release No. 89188 (June 30, 2020), 86 FR 40713 (July 7, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2020-019) and Letter from Gail Merken, Chief Compliance Officer, Fidelity Brokerage, Janet Dyer, Chief Compliance Officer, NFS & John McGinty, Chief Compliance Officer, Fidelity Distributors, to Vanessa Countryman, Secretary, SEC, dated February 16, 2022, in response to Securities Exchange Act Release No. 94018 (January 20, 2022), 87 FR 4072 (January 26, 2022) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2022-001).

and inspection findings in a uniform, comparable manner in the context of the emerging hybrid work model. FINRA anticipates that the proposed pilot program will provide broader systemized information to supplement the information obtained through the FINRA examination process in an environment where offices and locations were closed. The information firms will be required to produce as a pilot program participant will help FINRA 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.

Proposed Voluntary, Three-Year Pilot Program for Remote Inspections

With Rule 3110.17 operational since November 2020, and the widespread availability and use of technology described above, regulators are being challenged to consider whether on-site inspections by firms should be a necessity and if they continue to be an efficient and effective method for supervising and monitoring associated persons and offices as part of a firm's overall supervisory system.

As FINRA emphasized in the proposed rule change to adopt Rule 3110.17, the responsibility of firms to supervise their associated persons on a day-to-day basis is a critical component of broker-dealer regulation.³⁶ The inspection requirement in Rule 3110(c) is just one element of a reasonably designed supervisory system. FINRA believes that a pilot period of risk-based on-site supervision is consistent with firms' core responsibility, as set forth in Rule 3110, to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance

³⁶ See note 7, supra.

with applicable securities laws and regulations, and with applicable FINRA rules. The proposed pilot program would build largely on the terms of Rule 3110.17, but would be enhanced in several ways, including notably targeted exclusions from participation in the program for higher risk member firms, and offices or locations. In addition, the proposed pilot program would require a firm conduct a risk assessment for each office or location that is selected to be inspected remotely, documented with the factors considered. Finally, the proposed pilot program would require a firm to establish and maintain written supervisory procedures to account for the risk assessment and sets forth the scope of the program.

A. Scope of Pilot (Proposed Rule 3110.18(a))

Under proposed Rule 3110.18(a), the proposed pilot program would apply to the required inspections of OSJs, branch offices, and non-branch locations under the applicable provisions under Rule 3110(c)(1) for a pilot period of three years starting on the effective date, and expiring on a date that is three years after the effective date. If the proposed pilot program is not extended or Rule 3110.18, as may be amended, is not approved as permanent by the SEC, the proposed supplementary material will automatically sunset on a date that is three years after the effective date. In addition, proposed Rule 3110.18(a) would expressly state that members would not be able to avail themselves of the proposed pilot program after it expires.

B. Use of Remote Inspections (Proposed Rule 3110.18(b))

1. Risk-Based Approach; Risk Assessment (Proposed Rule 3110.18(b)(1))

As described above, Rule 3110(c)(1) provides that an inspection of an office or location must occur on a designated frequency, and the periodicity of the required

inspection varies depending on the classification of the location as an OSJ, branch office or non-branch location. Subject to proposed Rule 3110.18(b)(2) as described below, proposed Rule 3110.18(b)(1) would provide that a member firm may elect to conduct the applicable inspection of an office or location during the pilot period remotely, without necessarily an on-site visit for the office or location, when the member reasonably determines that the purposes of the rule can be accomplished by conducting such required inspection remotely.³⁷ Proposed Rule 3110.18(b)(1) would also provide that prior to electing a remote inspection for an office or location, rather than an on-site inspection, the firm must develop a reasonable risk-based approach to using remote inspections and conduct and document a risk assessment for that office or location. The assessment must document the factors considered, including the factors set forth in Rule 3110.12, and must take into account any higher risk activities that take place or higher risk associated persons that are assigned to that location. FINRA expects that higher risk factors at a particular location would cause a firm to conduct on-site inspections of such location. Further, under the proposed supplementary material, a member that is not eligible to conduct remote inspections under proposed Rule 3110.18(b)(2) must conduct an on-site inspection of that office or location on the required cycle. Finally, notwithstanding the pilot program, a member would remain subject to the other requirements and limitations of Rule 3110(c).³⁸

³⁷ As described further below, a member firm that elects to participate in the proposed pilot program would be subject to the requirements of proposed Rule 3110.18 for a Pilot Year. See proposed Rule 3110.18(g).

³⁸ For example, as currently required with any physical, on-site inspection, a member would be required to reduce the remote inspection to a written report and satisfy the content and record retention requirements of such report as described

2. Ineligible Member Firms, and Offices or Locations (Proposed Rule 3110.18(b)(2))

FINRA is proposing to exclude some member firms or their offices or locations from participating in the proposed pilot program. The proposed categories of ineligibility are events or activities of a member firm or its associated persons that FINRA believes are more likely to raise investor protection concerns based on the firm's or an associated person's record of specified regulatory or disciplinary events.

Under proposed Rule 3110.18(b)(2)(A), a member firm would be ineligible to conduct remote inspections of any of its offices if any time during the period of the proposed pilot program, the member is or becomes: (1) designated as a Restricted Firm under Rule 4111³⁹ (proposed Rule 3110.18(b)(2)(A)(i)); or (2) designated as a Taping Firm under Rule 3170⁴⁰ (proposed Rule 3110.18(b)(2)(A)(ii)). These rules expressly

in Rule 3110(c)(2). Similarly, a member would remain subject to Rule 3110(c)(3)'s general prohibition against an associated person from conducting a location's inspection if the person either is assigned to that location or is directly or indirectly supervised by, or otherwise reports to, someone assigned to that location. Rule 3110(c)(3) provides a limited exception from this general prohibition for specified circumstances (e.g., the member has a business model where a small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager) by requiring a member to document in the inspection report both the factors the member used to make the determination that it could not comply with the general prohibition and how the inspection otherwise complies with Rule 3110(c)(1).

³⁹ In general, Rule 4111 (Restricted Firm Obligations) requires member firms that are identified as "Restricted Firms" to deposit cash or qualified securities in a segregated, restricted account; adhere to specified conditions or restrictions; or comply with a combination of such obligations. See generally Regulatory Notice 21-34 (September 2021) (announcing FINRA's adoption of rules to address firms with a significant history of misconduct).

⁴⁰ In general, Rule 3170 (Tape Recording of Registered Persons by Certain Firms) requires a member firm to establish, enforce and maintain special written procedures supervising the telemarketing activities of all of its registered persons, including the tape recording of conversations, if the firm has hired more than a

address firms that pose higher risks, and for that reason, would be ineligible to participate in the proposed pilot program.

In addition, under proposed Rule 3110.18(b)(2)(B), a member firm’s office or location would be ineligible for a remote inspection if at any time during the period of the proposed pilot program, an associated person at such office or location is or becomes: (1) subject to a mandatory heightened supervisory plan under the rules of the SEC, FINRA or state regulatory agency (proposed Rule 3110.18(b)(2)(B)(i)); (2) statutorily disqualified, unless such disqualified person has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member and is not subject to a mandatory heightened supervisory plan under proposed Rule 3110.18(b)(2)(B)(i) or otherwise as a condition to approval or permission for such association (proposed Rule 3110.18(b)(2)(B)(ii)); (3) subject to Rule 1017(a)(7)⁴¹ as a result of one or more associated persons at such location (proposed Rule 3110.18(b)(2)(B)(iii)); or (4) one or more associated persons at such location has an event in the prior three years that required a “yes” response to any item in Questions 14A(1)(a)

specified percentage of registered persons from firms that meet FINRA Rule 3170's definition of “disciplined firm.” See generally Regulatory Notice 14-10 (March 2014) (announcing FINRA’s adoption of consolidated rules governing supervision).

⁴¹ In general, Rule 1017(a)(7) require a member firm to file a CMA when a natural person seeking to become an owner, control person, principal or registered person of the member firm has, in the prior five years, one or more defined “final criminal matters” or two or more “specified risk events” unless the member firm has submitted a written request to FINRA seeking a materiality consultation for the contemplated activity. Rule 1017(a)(7) applies whether the person is seeking to become an owner, control person, principal or registered person at the person’s current member firm or at a new member firm. See generally Regulatory Notice 21-09 (March 2021) (announcing FINRA’s adoption of rules to address brokers with a significant history of misconduct).

and 2(a), 14B(1)(a) and 2(a), 14C, 14D and 14E on Form U4⁴² (proposed Rule 3110.18(b)(2)(B)(iv)). FINRA believes that the imposition of a mandatory heightened supervisory plan, a statutorily disqualification, a Rule 1017(a)(7) review due to significant misconduct, or the existence of specified disclosures on Form U4 pertaining to criminal convictions and final regulatory action are indicia of increased risk to investors at some office or locations, such that they should not be eligible for remote inspections in accordance with the proposed pilot program.

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

⁴² Form U4's Questions 14A(1)(a) and 2(a), 14B(1)(a) and 2(a) elicit reporting of criminal convictions, and Questions 14C, 14D, and 14E pertain to regulatory action disclosures.

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

As part of an effective supervisory system tailored specifically to the member firm's business and the activities of all its associated persons, a member must establish and maintain written procedures.⁴³ Paragraph (1) (General Requirements) under Rule 3110(b) (Written Procedures) provides that a member must establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.

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

⁴³ See Rule 3110(a)(1); see generally Notice 99-45 and Regulatory Notice 18-15 (April 2018).

regulations, and of applicable FINRA rules.⁴⁴ To underscore the importance of Rule 3110(b)(1) in the context of the proposed pilot program, FINRA is proposing to add to the elements currently described under Rule 3110.17(b) an express provision that the firm must adopt written supervisory procedures regarding remote inspections that are reasonably designed to detect and prevent violations of and achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. In addition, a firm's written supervisory procedures should also include the factors considered in the risk assessment made for each applicable office or location pursuant to proposed Rule 3110.18(b).

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

FINRA is proposing to retain the terms of Rule 3110.17(c), without substantive change, in proposed Rule 3110.18(d). Similar to Rule 3110.17(c), proposed Rule 3110.18(d) would expressly reiterate the principle that the requirement to conduct inspections of offices and locations is one part of the member's overall ongoing obligation to have an effective supervisory system, and therefore a member must continue with its reviews of the activities and functions occurring at all offices and locations whether or not the member conducts inspections remotely. In addition, proposed Rule 3110.18(d) would provide that a member's remote inspection of an office or location would be held to the same standards for review applicable to on-site

⁴⁴ Offices or locations that may present a higher risk profile would include, for example, those that have associated persons engaging in activities that involve handling customer funds or securities, maintaining books and records as described under applicable federal securities laws and FINRA rules, order execution or other activities that may be more susceptible to higher risks of operational or sales practice wrongdoing, or have associated persons assigned to an office or location who may be subject to additional or heightened supervisory procedures.

inspections as set forth under Rule 3110.12.⁴⁵ Further, proposed Rule 3110.18(d) would provide that where a member's remote inspection of an office or location identifies any indicators of irregularities or misconduct (i.e., "red flags"), the member may need to impose additional supervisory procedures for that office or location, or may need to provide for more frequent monitoring or oversight of that office or location, or both, including potentially a subsequent physical, on-site visit on an announced or unannounced basis.

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

In general, Rule 3110(c)(2) imposes various documentation requirements for inspections, including maintaining a written record of the date upon which each inspection is conducted. Currently, Rule 3110.17(d) requires supplemental documentation by a member that avails itself of the remote inspection option. The member must maintain and preserve a centralized record for each of calendar years specified in the supplementary material that separately identifies: (1) all offices or locations that had inspections that were conducted remotely; and (2) any offices or locations that the member determined to impose additional supervisory procedures or more frequent monitoring, as provided in Rule 3110.17(c). A member's documentation of the results of a remote inspection for an office or location must identify any additional supervisory procedures or more frequent monitoring for that office or location that were imposed as a result of the remote inspection. FINRA is proposing to incorporate, without substantive change, the terms of Rule 3110.17(d) in proposed Rule 3110.18(e), but make two clarifying changes. One change would be to reference that the centralized record must

⁴⁵ See note 19, supra and accompanying text.

be for each of the “pilot years” (as defined in proposed Rule 3110.18(h)), and the other change would be to clarify that a member’s documentation of the results of a remote inspection for an office or location must identify any additional supervisory procedures or more frequent monitoring for that office or location that were imposed as a result of the remote inspection, including whether an on-site inspection was conducted at such office.

F. Data and Information Collection Requirement (Proposed Rule 3110.18(f))

1. Data and Information (Proposed Rule 3118.18(f)(1))

As noted above, Rule 3110.17 was adopted in the midst of the pandemic and operationalized in an environment in which many offices and locations were closed to the public. FINRA believes that the formalized, uniform collection of data is critical to allow FINRA to meaningfully assess the effectiveness of remote inspections to help shape potential permanent amendments to Rule 3110(c) that would optimize an inspection program in the evolving workplace environment. FINRA believes having a pilot program for remote inspections with appropriate conditions, limitations and documentation requirements in an environment that is resettling into a hybrid workplace model would provide a clearer picture of the strengths and weaknesses of remote inspections, without compromising investor protection. Proposed Rule 3110.18(f) would impose upon firms a data and information collection requirement as a condition for participating in the pilot program. On a frequency not to exceed quarterly, participating firms would be required to collect and produce to FINRA, in a manner and format determined by FINRA, data consisting of separate counts for OSJs, supervisory branch offices, non-supervisory branch offices, and non-branch locations, consistent with paragraphs (c)(1)(A), (B) and (C) under Rule 3110, for several categories, including: (1)

the total number of inspections—on-site and remote—completed during each calendar quarter;⁴⁶ (2) the number of those office or locations in each calendar quarter that were subject to an on-site inspection because of a “finding” (defined under proposed Rule 3110.18(f) as an item that led to any remedial action or was listed on the member’s inspection report);⁴⁷ (3) the number of locations for which a remote inspection was conducted in the calendar quarter that identified a finding, the number of findings, and a list of the most significant findings;⁴⁸ and (4) the number of locations for which a on-site inspection was conducted in the calendar quarter that identified a finding, the number of findings, a list of the most significant findings.⁴⁹ In addition, firms would be required to provide FINRA their written supervisory procedures for remote inspections that account for: (1) escalating significant findings; new hires; supervising brokers with a significant history of misconduct; and outside business activities and “doing business as” (or DBA) designations.⁵⁰ Firms would be required to provide FINRA with a copy of these written supervisory procedures alongside the first delivery of the data points described above, and any subsequent amendments to such procedures for remote inspections.⁵¹

⁴⁶ See proposed Rule 3110.18(f)(1)(A), (B) and (C).

⁴⁷ See proposed Rule 3110.18(f)(1)(D).

⁴⁸ See proposed Rule 3110.18(f)(1)(E).

⁴⁹ See proposed Rule 3110.18(f)(1)(F).

⁵⁰ See proposed Rule 3110.18(f)(1)(G)(i) through (iv).

⁵¹ See proposed Rule 3110.18(f)(1)(G).

2. Additional Data and Information for Pilot Year 1 (Proposed Rule 3110.18(f)(2))

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

3. Written Policies and Procedures (Proposed Rule 3110.18(f)(3))

Proposed Rule 3110.18(f)(3) would also remind firms of the general requirement to establish, maintain and enforce written policies and procedures that are reasonably designed to comply with the data and information collection, and transmission requirements of the proposed pilot program.

4. Remote Inspections Pilot Program Participation (Proposed Rule 3110.18(g))

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

Proposed Rule 3110.18(g) would require a firm, at least five calendar days before the beginning of such Pilot Year, to provide FINRA an "opt-in notice" in the manner and format determined by FINRA. By providing such opt-in notice to FINRA, the firm agrees to participate in the proposed pilot program for the duration of such Pilot Year and to comply with the requirements of Rule 3110.18.⁵² A firm that provides the opt-in notice for a Pilot Year would be automatically deemed to have elected and agreed to participate in the Remote Inspections Pilot Program for subsequent Pilot Years (i.e., Pilot Year 2, Pilot Year 3, and Pilot Year 4, if applicable) until the pilot program expires. Further, proposed Rule 3110.18(g) would describe the notice requirement for a firm to withdraw from the proposed pilot program. A firm would be required to provide FINRA with an "opt-out notice" at least five calendar days before the end of the then current Pilot Year.

By way of example, a firm that provides FINRA an opt-in notice on June 26 to join Pilot Year 1 that begins on July 1 would be automatically deemed to continue participating in Pilot Year 2 unless the firm provides FINRA the required opt-out notice

⁵² A firm that participates in a Pilot Year would be committed to complying with the terms of proposed Rule 3110.18 for that Pilot Year.

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

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

5. Definitions (Proposed Rule 3110.18(h))

Proposed Rule 3110.18(h) would set forth the meanings underlying "Pilot Year" to explain the duration of the proposed pilot program. Under proposed Rule 3110.18(h), a "Pilot Year" would mean the following: (1) Pilot Year 1 would be the period beginning on the effective date of the proposed pilot program and ending on December 31 of the same year; (2) Pilot Year 2 would mean the calendar year period following Pilot Year 1, beginning on January 1 and ending on December 31; and (3) Pilot Year 3 would mean the calendar year period following Pilot Year 2, beginning on January 1 and ending on December 31. Finally, if applicable, where Pilot Year 1 covers a period that is less than a full calendar year, then Pilot Year 4 would mean the period following Pilot Year 3, beginning on January 1 and ending on a date that is three years after the effective date.

6. Failure to Satisfy Conditions (Proposed Rule 3110.18(i))

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

7. Sunset of Rule 3110.17 (Proposed Rule 3110.18(j))

Proposed Rule 3110.18 would expressly account for the possibility that the proposed pilot program becomes effective while Rule 3110.17 is in effect to avoid overlapping provisions. Proposed paragraph (j) would provide that if Rule 3110.17 has not already expired by its own terms, it would automatically sunset on the effective date of proposed Rule 3110.18.

Consistent with the principles set forth in prior guidance, FINRA expects members to establish reasonably designed inspection programs. The proposed pilot program for remote inspections does not alter the core obligation of a member firm to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.⁵³ As part of the inspection planning process, FINRA expects members to continue with their ongoing supervision, including risk analysis of the activities and functions occurring at all offices or locations. While the

⁵³ See Rule 3110(a).

option to conduct remote inspections provides greater choice in how to effectively supervise some offices or locations, a member must continue to consider the factors described in Rule 3110.12, along with the activities taking place there. This analysis may require the member to conduct a physical, on-site inspection of an office or location. Where there are indications of problems or red flags at any office or location, FINRA expects members to investigate them as they would for any other office or location subject to Rule 3110(c), which may include an unannounced, on-site inspection of the office or location. FINRA is committed to diligently monitoring the impacts of remote inspections on a firms' overall supervisory systems and reviewing the data over the life of the proposed pilot program to assess how firms apply the flexibility provided by the pilot program while maintaining an effective supervisory program.

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

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁵⁴ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

The terms of the proposed voluntary, three-year remote inspection pilot program, while based largely on the terms of Rule 3110.17, which has been operational since the latter part of 2020 and is set to automatically sunset on December 31, 2022, would

⁵⁴ 15 U.S.C. 78q-3(b)(6).

include important safeguards that would require individual risk assessments of each office, supplemental written supervisory procedures related to remote inspections, documentation requirements and obligations to share data with FINRA to allow for assessment of the pilot program. The proposed rule change is intended to provide firms that are transitioning to a hybrid work environment the option to conduct remote inspections of their offices and locations, subject to specified conditions, while maintaining effective supervision. FINRA believes that the proposed pilot program would provide FINRA the appropriate amount of time and population sample to better evaluate the use of remote inspections in the unfolding office work environment. FINRA believes the proposed pilot program, with the proposed safeguards and controls, will provide firms more flexibility to adapt to changing work conditions. The proposed pilot program would aid in FINRA's assessment of the effectiveness of a flexible remote inspection option and its utility in an environment that is increasingly moving to hybrid workplace models, without compromising investor protection.

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

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to

the current baseline, and the alternatives FINRA considered in assessing how best to meet FINRA's regulatory objectives.

1. Regulatory Need

The proposed pilot program would serve two purposes. First, it would mitigate potential disruptions to the hybrid work arrangements that have developed during the pandemic. In particular, for participating members, the proposed pilot program would limit the increase in aggregate inspection costs, and the resulting incentive to reduce the number and type of work locations, that would occur when temporary relief provided during the pandemic expires.⁵⁵ The proposed pilot program would not eliminate the need for such adjustments, but it would allow member firms to focus their on-site inspections on riskier locations.

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

⁵⁵ According to the April Survey of Working Arrangements and Attitudes (SWAA), post-COVID, many employers are planning to allow employees to work from home between two and three days per week. See Jose Maria Barrero, Nicholas Bloom & Steven J. Davis, SWAA April 2022 (April 11, 2022), https://wfhresearch.com/wp-content/uploads/2022/04/WFHResearch_updates-April-2022.pdf. The number of expected work-from-home days post-pandemic has been increasing steadily since the January 2021 survey. The SWAA is monthly survey with respondents that are working-age persons in the United States that had earnings of at least \$20,000 in 2019. Further details about this survey can be found in <https://wfhresearch.com>.

conditional on the type and frequency of inspections, as well as the type of office or location inspected.

2. Economic Baseline

The economic baseline for the proposed rule change includes both current and foreseeable workforce arrangements and business practices, including those that were first developed during the pandemic and have been modified since. In particular, the economic baseline includes the innovations, and investments in communication and surveillance technology, that have supported and continue to support supervision in the remote work environment.⁵⁶ These innovations and investments were developed during the temporary relief allowing remote inspections in Rule 3110.17, and the temporary suspension of the requirement to submit branch office applications on Form BR for new office locations provided in Notice 20-08. The baseline includes the scheduled expiration of Rule 3110.17 on the effective date of the proposed Rule 3110.18; and, in order to provide a full accounting of the likely effects of the proposed rule change, the analysis also assumes that, going forward, the temporary suspension of the above requirement is no longer in effect. FINRA expects that numerous additional office locations would then need to be registered, greatly expanding the number of inspections, and all inspections would then need to be conducted on-site.

⁵⁶ The pandemic propelled increased reliance on technology solutions in the remote work environment. A Thompson Reuters survey of compliance and risk practitioners shows a 70% increase in the reliance on technological solutions and 30% of respondents expected increases in the budget for RegTech solutions, specifically. See Thompson Reuters, FinTech, RegTech and the Role of Compliance 2021, <https://legal.thomsonreuters.com/content/dam/ewp-m/documents/legal/en/pdf/reports/fintech-regtech-and-the-role-of-compliance-in-2021.pdf>.

As of April 30, 2022, FINRA’s membership included 3,365 firms with 151,463 registered branch offices.⁵⁷ Of these branch offices, 18,290 (12%) are OSJs subject to an annual inspection requirement. The remaining 133,173 branch locations are non-OSJ branch offices subject to an inspection requirement at least annually or every three years. In addition, according to FINRA estimates, there are more than 66,054 non-branch locations, of which 37,290 are private residences.⁵⁸ A non-branch location must be inspected on a periodic schedule, presumed to be at least every three years. These data may be affected by the temporary relief from certain requirements to update Form U4 and to submit Form BR provided in Notice 20-08. FINRA estimates that member firms conduct approximately 84,700 inspections per year.

FINRA adopted temporary Rule 3110.17 in late 2020 and the temporary rule has been extended twice since.⁵⁹ Hence, as of June 2022, member firms have been able to conduct remote inspections for 18 months. FINRA staff considered findings from FINRA’s examination of member firms and their branch locations that took place in between 2018 and 2021. This preliminary review found no significant departures relative to pre-pandemic examination results.⁶⁰

⁵⁷ This count excludes firms with membership pending approval, and withdrawn or terminated from membership.

⁵⁸ Non-branch locations do not have to be registered with FINRA. The estimates for non-branch locations, including those that are also private residences, are obtained by reviewing Form U4. There may be some double counting of non-branch locations if members record the address differently on more than one Form U4 (e.g., use “St.” on one and “Street” on another).

⁵⁹ See notes 7 and 33, supra.

⁶⁰ FINRA examinations generally review member activities for the year preceding the examination, and the vast majority of examinations takes place during the first 10 months of the calendar year. Examinations check for compliance with federal

3. Economic Impacts

As discussed above, absent the proposed rule change, FINRA expects that numerous additional office locations will need to be registered, greatly expanding the number of inspections, and all inspections would then need to be conducted on site. The economic impacts of these changes would be mitigated by the proposed rule change for firms that choose to participate in the pilot program.⁶¹

Participants in the pilot program would be expected to take a risk-based approach to conducting remote inspections. A firm that does not conduct a remote inspection for an office or location must conduct an on-site inspection of that office or location on the required cycle and remains subject to the other requirements of Rule 3110(c). A firm that

laws, rules and regulations; the specific areas examined in a firm are based on the risk profile of the firm. FINRA publishes an annual summary of key observations and best practices across all examinations. See the published reports at <https://www.finra.org/rules-guidance/key-topics/finra-examination-risk-monitoring-programs#guidance>. Due to this time lag in FINRA examinations, findings may reflect decisions about remote inspections made by members preceding examinations up to 12 months. Hence, most FINRA examinations in 2020 will reflect member planning undertaken prior to the adoption of Rule 3110.17. Conversely, 66% of FINRA examinations for calendar 2021 have not been finalized. In addition, FINRA examinations of member firms and their activities are risk-based. Given the focus on higher risk firms and some variations in the areas of focus in examinations, year-on-year comparisons should be treated with caution.

⁶¹ Separately, FINRA has filed a proposed rule change to establish a Residential Supervisory Location (“RSL”), a new non-branch location, that would, relative to the baseline, reduce the number of inspections that members with RSLs would need to conduct in a year. See Securities Exchange Act Release No. 95379 (July 27, 2022) (Notice of Filing of File No. SR-FINRA-2022-019). For member firms with locations that would meet the proposed definition of an RSL, the aggregate cost savings from choosing to participate in the proposed pilot program would be lower if the RSL proposal were in place because the cost savings from remote inspections would accrue over fewer inspections. The qualitative impacts of the proposed pilot program, however, are similar whether the proposed definition of an RSL is adopted or not.

chooses to participate in the pilot program (assuming that it is not otherwise ineligible from participating) would also be required to provide FINRA with certain data and other information about the risk-based approach that they implement, the type and frequency of inspections, and certain outcomes conditional on the type and frequency of inspections.

Anticipated Benefits

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

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

The proposed rule change may also support the competitiveness of the broker-dealer industry for individuals who seek professional positions in compliance.⁶² The

⁶² See note 56, *supra*. See also Jose Maria Barrero, Nicholas Bloom & Steven J. Davis, *Why Working from Home Will Stick* (NBER Working Paper 28731, April 2021), <https://wfhresearch.com/wp-content/uploads/2021/04/w28731-3-May-2021.pdf>, who point to a lasting effect of the pandemic on work arrangements, in particular for those with higher education and earnings; and Alexander Bick,

expectation of workplace flexibility and remote work by such individuals may lead them away from the broker-dealer industry if other segments of financial services or professional occupations offer more flexible workforce arrangements, with regulatory frameworks that offer more discretion in how the supervision is conducted.⁶³ Even prior to the pandemic, the scope of on-site inspections had been much reduced due to technological surveillance solutions and centralization of books and records. The proposed pilot would support continued adoption and innovation in technological solutions and reductions in the cost of these solutions.

Participants in the proposed pilot program would provide FINRA with periodic (not to exceed quarterly) data on the frequency and type of inspections (on-site or remote), counts of findings from inspections subdivided by category of office or location, qualitative information about these findings, and certain information about the written supervisory procedures for remote inspections they are required to have.⁶⁴ Depending on the number and types of firms that participate in the proposed pilot program, this data may allow FINRA to identify differences in risks between remote versus on-site inspection, both conditional on the observable characteristics and policies of firms and

Adam Blandin & Karel Mertens, *Work from Home Before and After the COVID-19 Outbreak*, (Working Paper, February 2022), https://karelmertenscom.files.wordpress.com/2022/02/wfh_feb17_2022_paper.pdf, who find consistent results, with a higher adoption rate of work from home jobs in Finance and Insurance, relative to other industries, reflected in Figure 10.

⁶³ For example, Advisers Act Rule 206(4)-7 does not require Registered Investment Advisers to conduct in-person inspections or reviews of its offices or personnel.

⁶⁴ In addition, if the effective date of the rule is such that the first year of the pilot program covers a period less than a full calendar year, participating firms would be required to provide, the data and information specified in proposed Rule 3110.18(f)(2).

overall, the extent of variation in these risks across firms and firm characteristics, and factors associated with very high or low risks. The proposed pilot program has the potential to yield a more thorough collection of sensitive information in a structured manner than voluntary submissions or a survey of FINRA members could provide. This data will be useful both for monitoring for risks as the pilot proceeds and, with sufficient participation, for developing a balanced assessment of the potential impact of permitting further remote inspection.

Anticipated Costs

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

Supervision and inspections are intended to identify not only the activities that violate member procedures or FINRA rules but also poor practices that might ultimately allow for such violations. FINRA recognizes that remote inspections may be less likely to identify such practices or activities as on-site inspections. FINRA believes that risks to member firms and investors from remote inspections are mitigated by the proposed requirements to have written supervisory procedures for remote inspections, the proposed requirement to conduct and document risk assessments, the proposed limitations on the firms and locations that would be eligible to participate in the proposed pilot program, and the technology already employed for day-to-day supervision. In addition, FINRA will continue to closely monitor the outcomes of examinations during the pilot program period.

4. Alternatives Considered

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

FINRA staff also considered a proposed pilot program that would not exclude certain firms, like restricted firms, from participating in the program. These additional

restrictions will limit the availability of the pilot program as well as the potential learnings from the program. As a result, the same restrictions may ultimately need to be carried over into any ongoing program of risk-based examinations. The exclusion of such firms, however, should reduce any risk of customer harm from not having on-site inspections.⁶⁵

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

Written comments were neither solicited nor received.

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

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

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

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

⁶⁵ See Zachary T. Kowaleski, Andrew G. Sutherland & Felix W. Vetter, Supervisor Influence on Employee Financial Misconduct (Working Paper, July 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3646617. This paper presents evidence that could be interpreted as supportive of the exclusions based on misconduct and lack of experience.

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2022-021 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-FINRA-2022-021. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only

information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2022-021 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁶⁶

J. Matthew DeLesDernier,
Deputy Secretary.

⁶⁶ 17 CFR 200.30-3(a)(12).