

Remote Branch Office Inspections

FINRA Requests Comment on a Proposal to Amend Rule 3110 (Supervision) to Provide Firms the Option to Conduct Remote Inspections of Offices and Locations That Meet Specified Criteria

Comment Period Expires: January 12, 2018

Summary

This *Notice* seeks comment on a proposal to amend Rule 3110 to add new Supplementary Material .15¹ to provide firms with the flexibility to conduct remote inspections of “qualifying offices” that meet specified criteria, in lieu of physical, on-site inspections of such offices as currently required under the rule.²

The proposed rule text is available in Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Philip Shaikun, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8451; or
- ▶ Sarah Kwak, Counsel, OGC, at (202) 728-8471.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by **January 12, 2018**.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

November 13, 2017

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Internal Audit
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Risk
- ▶ Senior Management
- ▶ Training

Key Topics

- ▶ Branch Office Inspections
- ▶ Risk Management
- ▶ Supervision

Referenced Rules & Notices

- ▶ FINRA Rule 3110
- ▶ Notice to Members 98-38
- ▶ Regulatory Notice 11-54

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.³

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC or Commission) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (Exchange Act).⁴

Background & Discussion

The responsibility of firms to supervise their associated persons is a critical component of federal broker-dealer regulation.⁵ This obligation is derived from Sections 15(b)(4)(E)⁶ and 15(b)(6)(A)⁷ of the Exchange Act, which authorize the SEC to impose sanctions on a firm or any person that fails to reasonably supervise a person subject to their supervision that commits a violation of the federal securities laws. Firms must supervise all of their associated persons, regardless of their location, compensation or employment arrangement, or registration status, in accordance with FINRA By-Laws and rules.⁸

FINRA's Supervision Rule, Rule 3110, requires each 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. Rule 3110(c) requires each firm to review, at least annually (on a calendar-year basis), the businesses in which it engages. The review must be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable FINRA rules. The rule requires that a firm review the activities of each office and inspect each office on a specified cycle depending on the office classification.⁹ FINRA has interpreted the rule to require that inspections take place on-site, irrespective of the type of office.¹⁰

Supplementary Material for the Supervision Rule, Rule 3110.12, elaborates on the inspection requirement and emphasizes the importance of supervising remote locations. That provision states that each member must establish and maintain supervisory procedures that take into consideration, among other things, the firm's size, organizational structure, scope of business activities, number and location of the firm's offices, the nature and complexity of the products and services offered by the firm, 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"). The provision further states that the procedures established and reviews conducted must provide that the quality of supervision at remote 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 accords with the principles set out in SEC staff guidance on the elements of effective supervision of small, remote (or geographically dispersed) offices.¹¹ The SEC guidance emphasizes the importance of inspections and encourages unannounced on-site inspections either on a random basis or where there are red flags about unusual activity in those offices.

Over the last few years, firms have raised questions about the manner in which they must conduct the internal inspections, particularly for those offices or locations with a limited number of associated persons or where only operational or limited supervisory functions take place. These locations often include personal residences of an associated person, an office of convenience where an associated person may meet a customer occasionally and exclusively by appointment, an office used by “circuit riders,” or other public places. Firms have noted that advances in communications technology and increased acceptance of flexible work arrangements have made remote locations more commonplace. They have further noted that most such locations do not hold themselves out to the public as a place where securities business takes place and engage in low-risk activity, with no books or records or funds or securities kept on the premises.

In light of these factors, and in recognition of the fact that technology already plays a prominent role in how firms conduct office inspections, firms have questioned the practicality and efficiency of conducting on-site inspections of such locations in fulfilling their obligations under Rule 3110(c). Among other things, they note the travel and related expenses incurred in connection with on-site inspections of these low-risk locations and have suggested that those resources could be better allocated to higher risk activities. Accordingly, the proposal seeks to reduce the burden of on-site inspections in limited circumstances that would not result in a diminution in investor protection.

Proposal

FINRA is proposing to adopt new Supplementary Material .15 (Remote Inspections), which would give firms the option to fulfill their obligations under Rule 3110(c) by conducting a remote inspection of a “qualifying office,” in lieu of a physical, on-site inspection of such office. Specifically, proposed Rule 3110.15(a) would require a firm that conducts remote inspections to have policies and procedures reasonably designed to determine whether a location is eligible for remote inspection as a “qualifying office” and to assess whether a remote inspection of any such office is reasonable.

In making the latter assessment, the proposal would require a firm to consider the factors set forth in Rule 3110.12, as well as whether any associated person that conducts business at the designated office or location has an event that is disclosed, or is or was required to be disclosed, under Questions 14C through 14J of that person's Form U4. These questions include adjudicated matters by federal and state regulatory agencies, self-regulatory organizations and foreign financial regulatory agencies, and settlements of investment-related civil complaints and arbitration claims above specified thresholds. The questions also include some unadjudicated regulatory complaints, investigations and arbitration claims. Under the proposal, these disclosures would be treated as red flags in determining whether it is reasonable to conduct a remote inspection of such office or location. The proposal would further require that, if a firm determines to proceed with a remote inspection where there has been such a reportable disclosure event, the firm must document, in writing, the basis for that determination.

Proposed Rule 3110.15(b) would define a "qualifying office" as an office or location that meets the following conditions:

- (1) not more than three associated persons that conduct business for the firm are designated to the location;
- (2) the location is not held out to the public as an office of the firm;
- (3) the associated person(s) at the location conducts business, including electronic communications, on behalf of the member at that location solely through the use of the firm's authorized electronic systems and platforms;
- (4) all books or records required to be made and preserved by the member under the federal securities laws or FINRA rules are maintained by the member other than at the location;
- (5) no customer funds or securities are handled at the location;
- (6) the location is either (i) not required to be inspected annually pursuant to Rule 3110(c)(1)(A); (ii) designated as an OSJ solely because of the supervisory activities described in Rule 3110(f)(1)(D) through (G);¹² or (iii) designated as a branch office solely because of the supervisory activities described in Rule 3110(f)(2)(B);¹³ and
- (7) no registered person at the location has a disciplinary history (as defined in Rule 3170(a)(3))¹⁴ and no associated person at the location is subject to a statutory disqualification.

Under the proposal, remote inspections would be subject to the same qualitative standard as on-site inspections in that they must be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with FINRA rules. As with on-site inspections, remote inspection reports would be required to be written and kept on file for the periods of time specified for the relevant inspection cycle.

Preliminary Economic Impact Assessment

Need for the Rule

FINRA recognizes the prominent role that technology already plays in conducting office inspections. Technological advances have significantly reduced the costs of performing inspections. The resources firms expend to conduct on-site inspections of low-risk offices or locations could be better allocated to higher risk activities. As such, the proposal is intended to address the changes in the technological landscape and provide firms another effective way to perform inspections that is cost efficient without diminishing investor protection.

Economic Baseline

The economic baseline for the proposal is the current inspection requirement for supervision of offices and locations in Rule 3110. To comply with the existing inspection requirement, firms must perform on-site inspections of OSJs and supervising branch offices at least annually (on a calendar-year basis), non-supervisory branch offices at least every three years, and non-branch locations on a regular periodic schedule with a presumption of at least every three years. The inspection process requires sending an associated person to perform an on-site inspection, incurring both travel costs and travel-related lost work hours of the associated person conducting the inspection. The proposal provides for an alternative, cost efficient inspection framework for offices and locations that meet the proposed criteria.

Based on data available as of October 2017, firms conduct approximately 86,500 on-site inspections annually, of which approximately 21,000 are for OSJs or supervisory branch offices and approximately 65,500 are for non-supervisory branch offices and non-branch locations.¹⁵

Economic Impact

FINRA does not believe that the proposal adds new burdens on firms. The use of remote inspections is optional. The proposal overall is expected to lend some practical relief to firms in fulfilling their obligations under Rule 3110(c) such as a reduction in travel costs, as well as lost productivity during travel. In addition, the proposal would foster the opportunity for firms to enhance their risk management programs by providing firms with the flexibility to conduct remote inspections on a more frequent cycle or to use the additional compliance resources on inspecting offices or locations at which associated persons engage in higher risk activities. Further, remote inspections allow firms to assign more firm personnel to conduct inspections without incurring undue additional costs. Giving firms the option to have more than one person conduct an inspection may create training opportunities that would help firms improve the inspection process, and also potentially enhance compliance practices.

A firm would be required to implement the appropriate infrastructure to conduct remote inspections to the extent it does not already exist. Such infrastructure would need to address cybersecurity issues, such as unauthorized access to personally identifiable information, potentially exacerbated by the remote inspection process. A potential indirect cost of the proposed amendments is the increased risk that the inspection process does not properly identify ongoing misconduct, or the risk for future misconduct, by the associated persons at the office or location. Broker misconduct could remain unidentified for a longer period of time without a physical presence by oversight staff at the office or location. The stringent proposed criteria that members must apply to branch offices and non-branch locations to determine whether they are eligible for remote inspection are designed to largely mitigate these risks.

FINRA recognizes that not all branch offices and non-branch locations will be able to benefit from the new option due to the conditions defining a “qualifying office.” For example, the first condition of a “qualifying office” limits the location to no more than three associated persons designated to that location. To provide a sense of the scope of the population of offices or locations that may meet this criterion, of the approximately 138,500 non-supervisory branch offices as of October 2017, approximately 11,500 have three registered persons designated to that office, approximately 27,000 have two registered persons designated to that office, and approximately 83,000 have one registered person designated to that office. The remaining 17,000 have more than three registered persons designated to that office. In addition to non-supervisory branch offices, of the approximately 21,000 OSJs or supervisory branch offices, approximately 2,100 have three registered persons designated to that office, approximately 2,800 have two registered persons designated to that office, and approximately 3,500 have one registered person designated to that office. The remaining 12,600 have more than three registered persons designated to that office. Finally, approximately 81,000 registered persons are located at the approximately 58,000 non-branch locations, averaging 1.4 registered persons per non-branch location. Branch offices and non-branch locations may also have non-registered associated persons located there. Moreover, a location that meets the threshold for the number of associated persons designated to such location would not necessarily meet the other criteria for a “qualifying office.” Thus, these numbers put an upper bound on the number of locations that meet the definition of “qualifying office.”

Alternatives Considered

FINRA considered a range of suggestions in developing the proposal. The alternatives to the proposed amendments included an alternative definition of the number of associated persons for the definition of a qualifying office, and alternative criteria and conditions regarding associated person misconduct as a prerequisite for eligibility for remote inspections. The proposal reflects the changes that FINRA believes strike the appropriate balance to address the concerns of firms while preserving the investor protection purposes of an inspection requirement.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues:

1. How does the firm currently fulfill its obligations under Rule 3110(c) for those offices or locations at which few associated persons reside and limited or low-risk activities occur? In what way(s) would the use of remote inspections impact the firm's current inspection process or practices?
2. Should a firm with a disciplinary history of supervisory violations or other investment-related violations be able to avail itself of the option to conduct remote inspections?
3. Are there other criteria for a "qualifying office" that should be considered? For example:
 - a. The proposal requires a firm to determine whether a remote inspection of a qualifying office would be reasonable by considering the factors set forth under Rule 3110.12 including the volume of business. Should a threshold be imposed on the volume of business generated from the qualifying office, or should offices that are responsible for a significant proportion of a firm's business be excluded from the definition?
 - b. Should there be a prerequisite that a firm must have conducted an on-site inspection of an office or location before such office or location could become a qualifying office?
 - c. Should the firm be required to conduct an interview with the associated person(s) designated to the qualifying office by video conference or in-person at any mutually agreed upon office or location?
 - d. Should there be a minimum distance between the qualifying office and the OSJ or supervisory branch office?

Please provide specific thresholds and the underlying rationale for the thresholds.

4. The proposal seeks to limit the number of associated persons designated to a qualifying office to three. Is this threshold reasonable? If not, why not? Is there a more appropriate threshold and why?

Please provide a specific threshold and the underlying rationale for the threshold.

5. Are there criteria for a qualifying office that should be excluded?
6. Does the proposal have any potential negative impacts on a firm's ability to fulfill its obligations under Rule 3110(c)?

7. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
 - a. What are these economic impacts and what are their primary sources?
 - b. To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?
 - c. To what extent would these economic impacts affect existing business models and existing organizational structures?
 - d. What would be the magnitude of these impacts, including costs and benefits (*e.g.*, travel, infrastructure, human resources)?
 - e. How many and what percentage of your firm's branch offices and non-branch locations do you estimate would be able to take advantage of the remote inspection option?
8. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. FINRA also proposes to delete existing Supplementary Material .15 (Temporary Program to Address Underreported Form U4 Information) as obsolete.
2. Earlier this year, FINRA announced a new initiative—called FINRA360—to evaluate various aspects of its operations and programs to identify opportunities to more effectively further its mission. As part of this initiative, FINRA received comments on the effectiveness and efficiency of its rules, operations and administrative processes governing broker-dealer activities. One concern raised by firms was about the manner in which they must conduct internal inspections of firm offices under Rule 3110, particularly for those offices or locations with a limited number of associated persons or where only operational or limited supervisory functions take place. See [Special Notice 03/21/17](#), Engagement Initiative.
3. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. See [Notice to Members 03-73](#) (November 2003) (Online Availability of Comments) for more information.
4. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
5. See SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (SEC Staff Legal Bulletin No. 17), available at <https://www.sec.gov/interps/legal/mrslb17.htm>.
6. 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, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that 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 Exchange Act], 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).
7. 15 U.S.C. § 78o(b)(6)(A) (authorizing the Commission to impose sanctions on any associated person of a broker-dealer that violates the federal securities laws).
8. See [Regulatory Notice 11-54](#) (November 2011) and [Notice to Members 98-38](#) (May 1998).
9. Firms must inspect offices of supervisory jurisdiction (OSJs) and supervising branch offices every year, non-supervisory branch offices at least every three years, and non-branch locations on a regular periodic schedule with a presumption of least every three years. See Rules 3110(c)(1) and 3110.13.

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10. See *Regulatory Notice 11-54* (November 2011).
11. See SEC Staff Legal Bulletin No. 17.
12. These supervisory activities involve final acceptance (approval) of new accounts, review and endorsement of customer orders, final approval of retail communications other than research reports, or responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member. An office that is designated as an OSJ because of the supervisory activities described in Rule 3110(f)(1)(A) through (C)—order execution or market making, structuring of public offerings or private placements, or maintaining custody of customers' funds or securities—would not meet the conditions to become a “qualifying office.”
13. Rule 3110(f)(2)(B) provides that any location that is responsible for supervising the activities of persons associated with the member at one or more non-branch locations of the member is considered to be a branch office.
14. Rule 3170(a)(3) defines “disciplinary history” as a finding of a violation by a registered person in the past five years by the SEC, a self-regulatory organization, or a foreign financial regulatory authority of a litany of specified rules.
15. As of October 2017, there are 3,731 firms with approximately 21,000 OSJs or supervisory branch offices that are required to be inspected at least annually, approximately 138,500 non-supervisory branch offices that are required to be inspected at least every three years, and approximately 58,000 non-branch locations that are required to be inspected on a regular periodic schedule, presumed to be at least every three years.

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

3000. SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

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3100. Supervisory Responsibilities

* * * * *

3110. Supervision

(a) through (f) No Change.

• • • Supplementary Material: -----

.01 through .14 No Change

.15 Remote Inspections.

(a) In fulfilling its obligations under Rule 3110(c), a member may determine to conduct a remote inspection of a “qualifying office” (as defined in this Supplementary Material) in lieu of a physical, on-site inspection of such office. A member that conducts remote inspections must have policies and procedures reasonably designed to determine whether a location is eligible for remote inspection as a “qualifying office” and to assess whether a remote inspection of any such office is reasonable. To determine whether a remote inspection is reasonable, a member must consider the factors set forth in Rule 3110.12, as well as whether any associated person that conducts business designated to the location has an event that is disclosed, or is or was required to be disclosed, under Questions 14C through 14J on the person’s Form U4. If a member determines to conduct a remote inspection where there has been such a reportable disclosure event, the member must document in writing the basis for that determination.

(b) A “qualifying office” is a location that meets the following conditions:

(1) Not more than three associated persons that conduct business for the member are designated to the location;

(2) The location is not held out to the public as an office of the member;

(3) The associated person(s) at the location conducts business, including electronic communications, on behalf of the member at that location solely through the use of the member’s authorized electronic systems and platforms;

(4) All books or records required to be made and preserved by the member under the federal securities laws or FINRA rules are maintained by the member other than at the location;

(5) No customer funds or securities are handled at the location;

(6) The location is either (i) not required to be inspected annually pursuant to Rule 3110(c)(1)(A); (ii) designated as an OSJ solely because of the supervisory activities described in Rule 3110(f)(1)(D) through (G); or (iii) designated as a branch office solely because of the supervisory activities described in Rule 3110(f)(2)(B); and

(7) No registered person at the location has a disciplinary history (as defined in Rule 3170(a)(3)) and no associated person at the location is subject to a statutory disqualification.

[Temporary Program to Address Underreported Form U4 Information. FINRA is establishing a temporary program that will issue a refund to members of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M (unsatisfied judgments or liens) if the Form U4 amendment is filed between April 24, 2014 and December 1, 2015 and one of the following conditions is met: (1) the judgment or lien has been satisfied, and at the time it was unsatisfied, it was under \$5,000 and the date the judgment or lien was filed with a court (as reported on Form U4 Judgment/Lien DRP, Question 4.A.) was on or before August 13, 2012; or (2) the unsatisfied judgment or lien was satisfied within 30 days after the individual learned of the judgment or lien (as reported on Form U4 Judgment/Lien DRP, Question 4.B.). This program has a retroactive effective date of April 24, 2014, and it will automatically sunset on December 1, 2015. Members will not be able to use the program after December 1, 2015.]