



November 25, 2022

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

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

RE: File No. SR-FINRA-2022-019: Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110

Dear Assistant Secretary Taylor:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I am writing in response to U.S. Securities and Exchange Commission (“SEC” or the “Commission”) Release No. 34-96191, *Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110*.² The underlying proposed rule change (the “Proposal”)³ would treat a private residence at which an associated person engages in certain supervisory activities as a non-branch location. One of the principal effects of the Proposal would be to reduce the frequency of onsite supervisory inspections of these locations from annually to “presum[ably] . . . at least every three years.”⁴

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

² The Order Instituting Proceedings is available at <https://www.sec.gov/rules/sro/finra/2022/34-96191.pdf>.

³ See *Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110 (Supervision)*, SEC Rel. No. 34-95379 (July 27, 2022), available at <https://www.sec.gov/rules/sro/finra/2022/34-95379.pdf>.

⁴ FINRA Rule 3110.13; Notice of Filing of a Proposed Rule Change at 8.

NASAA submitted a comment letter addressing the Proposal on August 23, 2022.⁵ On October 31, 2022, FINRA submitted a letter responding to comments received by the Commission (the “Response to Comments”).⁶ FINRA contends that “the changes brought forth by the pandemic merit a reevaluation of the regulatory benefit of requiring firms to designate a private residence where lower risk activities are conducted as an OSJ or branch office.”⁷ However, neither the Proposal nor FINRA’s response to comments demonstrate a thorough “[e]valuation of the regulatory benefit,” let alone the regulatory risk, of loosening firm supervisory obligations. Weighing heaviest in opposition to approval of the Proposal is the fact that FINRA has not offered sufficient information and facts to demonstrate that reducing the frequency of supervisory inspections is warranted or appropriate. We reiterate and incorporate our previous comments, including our recommendation that the Commission withhold approval of the Proposal. However, if the Commission is generally inclined to approve the Proposal, we recommend that it not be approved without the changes described below.

I. FINRA Has Not Shown that Loosening Longstanding Supervisory Obligations Is Warranted or Appropriate.

In response to NASAA’s concern about the advisability of the Proposal, FINRA asserts that less frequent inspections are acceptable because the conditions for Residential Supervisory Location (“RSL”) status “confine RSL eligibility to a limited range of lower risk supervisory functions . . . subject to many of the same safeguards and conditions applied today to the residential non-branch locations”⁸ However, neither the Proposal nor the Response to Comments demonstrates that supervisory functions present sufficiently “lower risk” to warrant loosening oversight of the individuals performing those functions.

Although supervisory functions do not present the same kinds of risk as do sales activities, for example, the former are not “low risk” and are in fact an integral component of overall risk mitigation. Effective firm supervision of associated persons is a critical component of the broader investor protection framework under the state and federal securities laws. Associated persons performing supervisory functions are a first line of defense, compliance, and risk mitigation within their firms. Lax or otherwise ineffective supervision can result in the failure to stop preventable harms before they occur, or even exacerbate harms that have already begun. Thus, it is exceptionally important that supervisory functions be subject to regular scrutiny by firms to ensure that they are operating effectively. In fact, FINRA has already determined that offices of supervisory jurisdiction (“OSJs”) and supervisory branches must be inspected more frequently

⁵ The previous NASAA comment letter is available at <https://www.nasaa.org/wp-content/uploads/2022/08/2022-08-23-NASAA-Comment-Letter-on-SR-FINRA-2022-019-and-021-redacted.pdf>.

⁶ The Response to Comments is available at <https://www.sec.gov/comments/sr-finra-2022-019/srfinra2022019-20148574-314922.pdf>.

⁷ Response to Comments at 13.

⁸ Response to Comments at 5. *See also id.* at 4, 6, 13.

than non-supervisory branches and non-branch locations.⁹ Both FINRA and the SEC have long recognized that regular inspection is especially important for small, remote offices.¹⁰ This is not a mere theoretical exercise, as less frequent inspections could result in failures to promptly identify supervisory lapses and tangible investor harms. Although FINRA suggests that inspections under FINRA Rule 3110(c) are merely “one component of a reasonably designed supervisory system,”¹¹ FINRA does not propose to require firms to enhance other supervisory components to address the likely shortfall that would come with less frequent onsite inspections.

Further, the Proposal would not merely loosen firm oversight of important supervisory functions; it would also inhibit regulators’ ability to pick up the resulting slack. As noted by at least one commenter,¹² the Proposal would not create a “formal” categorization for RSLs or provide a mechanism for firms to identify and track RSLs on the Central Registration Depository (“CRD”). Instead, the Proposal would rely on member firms to maintain a list of their RSLs.¹³ State securities regulators use information in the CRD to effectively plan their examinations. However, the Proposal would undermine the ability of regulators to know whether and where firms have established RSLs where associated persons conduct important firm activities. While a regulator could ostensibly obtain this information from the firm, the Proposal does not require any particular manner of notice to the firm and it is not a given that the information would be complete or reliable. Requesting this information from the firm could also preclude regulators from conducting unannounced examinations, including in those circumstances where an unannounced examination may be most appropriate.

FINRA broadly cites “advances in technology” as support for the Proposal.¹⁴ These purported advances include cloud storage, internal access controls in firm systems, email controls, internet and social media reviews, remote desktop access programs, “web-based communication

⁹ Compare FINRA Rule 3110(c)(1)(A) (requiring member firms to inspect OSJs and supervisory branches “at least annually”) with 3110(c)(1)(B) (requiring member firms to inspect non-supervisory branches and non-branch locations “at least every three years”) and 3110.13 (noting that the three-year period is a “general presumption” and that member firms may establish “longer periodic inspection schedule[s]”).

¹⁰ See, e.g., FINRA, Regulatory Notice 14-10: Consolidated Supervision Rules (Mar. 2014), available at <https://www.finra.org/sites/default/files/NoticeDocument/p465940.pdf> (reminding firms to “conduct *focused reviews* of one-person OSJ locations”) (emphasis added); SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (Mar. 19, 2004), available at <https://www.sec.gov/tm/staff-legal-bulletin-17-remote-office-supervision> (“reminding broker-dealers that small, remote offices require *vigilant* supervision”) (emphasis added).

¹¹ See Response to Comments at 5.

¹² See Letter from Karol Sierra-Yanez, MML Investors Services, LLC, at 3 (Aug. 23, 2022) (“suggest[ing] that FINRA create a more formal categorization or appropriate system changes so firms can identify and track [RSLs] on CRD”).

¹³ See Proposed Rule 3110.19(a)(9).

¹⁴ See Response to Comments at 3.

programs,” and video conferencing applications, among other things.¹⁵ However, the Response to Comments does not explain how these purported technological advancements, many of which have existed for several years or more, are relevant to the frequency of inspections.¹⁶ If anything, these purported advances in technology militate against reducing the frequency of inspections. If it is true that technology has made effective supervision easier,¹⁷ then it should be less burdensome for firms to subject supervisory locations to frequent scrutiny.

In sum, FINRA has not shown that reducing firms’ longstanding supervisory obligations is warranted or appropriate. Supervisory offices should continue to be visited with the same frequency as they are currently because the importance of their work has not changed, and because firms need to understand how well supervisors are adapting to technological surveillance methods. Indeed, if anything, the widely adopted emergence of hybrid workforce models has made supervision more challenging, and firms need to be sure that their supervisors are operating effectively in this new environment.

While NASAA’s primary concern with the Proposal remains unchanged, if the Proposal is allowed to move forward, we recommend that it not be approved without certain changes described below.

II. The Ineligibility Criteria Are Insufficient as Proposed.

Since FINRA is proposing to loosen oversight of important supervisory functions, it is important that the proposed rules adequately screen out locations that would present an unacceptable risk as RSLs. Among other criteria, the Proposal would preclude a location from RSL status if someone at that location is subject to mandatory heightened supervision, or is or will be subject to certain regulatory actions. NASAA supports the premise underlying each of these criteria. However, they are materially underinclusive as proposed. These shortcomings need to be addressed before the Proposal is approved.

¹⁵ *Id.*

¹⁶ Many of the listed technologies have been widely available for years or longer, but have not warranted loosening firm supervisory obligations. The timing appears to be heavily influenced by member firms’ convenience, rather than a need to reduce the frequency of inspections.

¹⁷ *See, e.g.*, Response to Comments at 3 (noting with approval “the general view that advances in technology have facilitated remote supervision”); *Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)*, 3 (Aug. 9, 2022), available at <https://www.sec.gov/rules/sro/finra/2022/34-95452.pdf> (stating that “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”).

a. Heightened Supervisory Plans

Proposed Rule 3110.19(b)(6) should be augmented to expressly include a heightened supervisory plan “imposed by the member.”¹⁸ As proposed, it is not clear whether this condition would apply to a heightened supervisory plan imposed by a firm without regulatory action. This could potentially allow a firm to skirt this condition by imposing its own heightened supervisory plan in lieu of having a plan imposed by order or agreement of a regulator. If the circumstances warrant heightened supervision, the rule should draw no distinction between heightened supervision imposed by regulators or by firms.

b. Alleged Failure to Supervise

Proposed Rule 3110.19(b)(9) should be revised as follows to expressly apply to investigations, proceedings, complaints, and other actions alleging a failure to supervise with a view to preventing the violation of “any state law pertaining to the regulation of securities” and any rule or regulation thereunder.¹⁹ The Proposal appropriately recognizes that state regulatory actions should be considered on equal footing with federal regulatory actions, in the context of eligibility for RSL status. However, as proposed, the rule nullifies the inclusion of state regulatory actions in this condition by limiting its application to violations of the federal securities laws and self-regulatory organization (“SRO”) rules. Such a limitation does not make sense. State securities regulators are charged with enforcing state securities laws and their right to seek relief for misconduct is based on those laws. As such, state securities actions typically allege violations of state securities laws and regulations, even if the same conduct could also be a violation of federal securities laws or SRO rules. State securities laws generally require supervision to assure compliance with and prevent violations of the provisions in those specific laws.²⁰ The Proposal

¹⁸ This provision should be amended as follows:

one or more associated persons at such location is subject to a mandatory heightened supervisory plan under the rules of the SEC, FINRA or state regulatory agency, or imposed by the member.]

¹⁹ This provision should be amended as follows:

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

²⁰ See Uniform Securities Act (1956), § 204(a)(2)(J), available at <https://www.nasaa.org/wp-content/uploads/2011/08/UniformSecuritesAct1956withcomments.pdf> (authorizing discipline where a person has “failed reasonably to supervise [those subject to supervision] to assure their compliance with *this act*”) (emphasis added); Uniform Securities Act (2002), § 412(d)(9), available at <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=04eccc01b-d3d9-751d-9925-e5c4ca6c104f&forceDialog=0> (authorizing discipline where a person has “failed to reasonably

should reflect that reality. State securities laws are an important part of the regulatory framework and should not be treated differently with respect to assessments of regulatory and supervisory risks that the proposed ineligibility criteria are designed to address.

NASAA proposed this revision in its August comment letter.²¹ In the Response to Comments, FINRA declined to make this change, stating that the list of provisions in the rule is “derived from Form U4” and the proposed change “would create regulatory inconsistency and raise the difficulty of administering and supervising this element.”²² FINRA’s concerns are not well-founded for two reasons.

First, NASAA’s proposed revision would increase consistency with Form U4 and other provisions of the Proposal. Form U4 does not limit Question 14 to information about violations of the federal securities laws and SRO rules. For example, in Question 14D, Form U4 also asks whether a state regulatory agency has “found [the associated person] to have been involved in a violation of investment-related regulation(s) or statute(s),” or “entered an order against [the associated person] in connection with an investment-related activity.”²³ As discussed above, a “yes” answer to these items based on a state regulatory action will, almost by definition, be in reference to violations of *state* securities laws.

Furthermore, eligibility for RSL status does not rest on either a “yes” or “no” answer to Questions 14E(5)-(7). Those items do not ask whether an associated person is subject or will be subject to such an investigation or action; instead, they ask whether an SRO “has . . . ever found” the associated person to have violated the federal securities laws or SRO rules. FINRA offers no rationale for its apparent position that the language of proposed Rule 3110.19(b)(9) must be identical with Question 14E(5)-(7) and Question 14D must be disregarded. FINRA’s position is also inconsistent with other provisions in the Proposal. For example, proposed Rule 3110.19(b)(8) provides that a location is ineligible if “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 Question[] . . . 14D . . . on Form U4.”²⁴ FINRA offers no reason to conclude that direct violations of the state securities laws should be treated differently in this context from allegations that an associated person has failed to supervise someone as required under those laws.

Second, FINRA offers no support for its assertion that NASAA’s proposed change would “raise the difficulty of administering and supervising this element.” Proposed Rule 3110.19(b)(9) already applies to investigations and other actions by state securities regulators. FINRA has offered no reason to believe that it would be more difficult for either FINRA or its member firms

supervise [those subject to supervision, to prevent] a violation of *this [Act]* or the predecessor act”) (emphasis added).

²¹ See NASAA Letter, *supra* note 5, at 12-13.

²² Response to Comments at 12-13.

²³ Form U4, Question 14D(1)(b), (d).

²⁴ Proposed Rule 3110.19(b)(8).

to apply the ineligibility conditions to a state regulatory action alleging failure to supervise under the federal securities laws than to do the same with a state regulatory action alleging failure to supervise under the state securities laws.

FINRA has offered no further explanation for rejecting NASAA's suggested revision to proposed Rule 3110.19(b)(9). Accordingly, FINRA should revise this provision as suggested above before the Proposal is allowed to move forward.

III. The proposed recordkeeping requirements are too loose as proposed.

If the Commission is inclined to allow the Proposal to move forward, it also should not do so until proposed Rule 3110.19(a)(10) is revised as follows:

all books or records required to be made and preserved by the member under the federal securities laws or FINRA rules are created on the member's electronic systems, if created electronically, and are maintained by the member other than at the location on the member's electronic or other central recordkeeping systems.

NASAA previously suggested substantially this revision in its August 2022 letter. FINRA declined to adopt this suggestion on the grounds that it “would impose a new obligation on firms to create and maintain records in electronic form, which may not align with firms’ obligations generally under the SEC’s Books and Records Rules,” noting further that the applicable rules “allow broker-dealers to preserve records in other forms, such as in paper form.”²⁵ However, the core of NASAA’s suggestion is that the proposed standard – namely, “other than at the location” – is too broad. The rules should instead require that records be maintained in a place over which the firm has control and to which it has direct access. As written, the rule could be read to permit the maintenance of records practically anywhere, such as in a cloud storage account or customer relationship management system over which the firm does not have access or control. The lack of specificity inhibits a firm’s ability to supervise and monitor its associated persons centrally. It could also lead to misappropriation or misuse of sensitive customer information.²⁶ We have modified the language of our previous recommendation slightly to account for records that are created and maintained in paper form, but the salient point of the recommendation remains well-founded.

²⁵ Response to Comments at 9.

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

IV. Conclusion

In sum, NASAA requests that the SEC reject the Proposal until such time that FINRA can offer facts sufficient to demonstrate that reducing the frequency of inspections is warranted or appropriate. At minimum, the Proposal should not be approved without certain changes, detailed above. We acknowledge that updating the Proposal may require FINRA to resubmit it through the notice and comment process. However, given that FINRA is proposing to loosen firms' long-established supervisory obligations, it is imperative that the rules proposed to do so adequately account for the obvious and foreseeable risks.

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

Sincerely,

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

Andrew Hartnett
NASAA President and
Deputy Commissioner,
Iowa Insurance Division