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Sherry R. Haywood
Assistant Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. SR-FINRA-2022-021: Notice of Partial Amendment No. 1 to Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)

Dear Ms. Haywood:

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. 34-96520, *Notice of Partial Amendment No. 1 to Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)* (the "Proposed Amendment").[2] We reiterate and incorporate our previous comments on the underlying proposal,[3] and submit the following additional comments regarding the Proposed Amendment. The Proposed Amendment improves the pilot program proposal under consideration, and we appreciate FINRA's receptiveness to some of our concerns. Nonetheless, we continue to believe that additional guardrails are necessary before the pilot program can be considered appropriate for approval.

[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 Proposed Amendment is available at https://www.sec.gov/rules/sro/finra/2022/34-96520.pdf.

[3] *See* Letter from Andrew Hartnett, NASAA President and Deputy Commissioner, Iowa Insurance Division, to Sherry R. Haywood, Assistant Secretary, *Re: File No. SR-FINRA-2022-021* (Dec. 7, 2022), *available at* https://www.nasaa.org/wp-content/uploads/2022/12/NASAA-Comment-Letter-re-SR-FINRA-2022-021_12-07-2022.pdf; Letter from Melanie Senter Lubin, NASAA President and Maryland Securities Commissioner, to J. Matthew DeLesDernier, Assistant Secretary, *Re: File Nos. SR-FINRA-2022-021 and SR-FINRA-2022-019* (Aug. 23, 2022), *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.

I. Risk Assessment and Continued Use of In-Person Inspections

The Proposed Amendment would add new subparagraphs (b)(2) and (c)(1)(B)(ii) to proposed Rule 3110.18. Proposed subparagraph (b)(2) would specify certain risk factors that firms must consider as part of the risk assessment required in order to determine that an office or location can be inspected remotely. Proposed subparagraph (b)(2) further states that firms "should conduct on-site inspections or make more frequent use of unannounced, on-site inspections for high-risk locations or where there are 'red flags.'" Proposed subparagraph (c)(1)(B)(ii) would require firms, as part of the mandated risk assessment, to determine that their surveillance and technology tools are appropriate to supervise the types of risks presented by each office or location. These amendments are generally responsive to suggestions that we made in our December 7 letter, and we support their inclusion in proposed Rule 3110.18. Nonetheless, further enhancements should be made.

First, a firm that determines not to conduct an in-person inspection after identifying high risk factors or red flags should be required to document the basis for its decision and provide that information to FINRA during the pilot program. Although proposed subparagraph (b)(2) would help set normative expectations, the absence of an affirmative requirement to conduct an in-person inspection may result in some firms relying too heavily on remote inspections and reserving on-site inspections only for extraordinary circumstances. We understand that some firms may be reticent to conduct in-person inspections of home offices, for example, for fear of being perceived by personnel as overbearing or intrusive. This is one factor that could lead firms to conduct in-person inspections only in the most extraordinary situations, even if the risk factors merit an on-site visit or otherwise higher scrutiny. Requiring firms to document these decisions and provide the information to FINRA would help to maintain accountability by requiring firms to articulate a sound basis for these decisions based on analyses of the risks. It would also enhance FINRA's ability to oversee industry practices and supervise its members during the pilot program. This information is also integral to FINRA's and the SEC's ability to fully consider "potentially broader reliance on remote inspections" after the pilot program.[4] These important policy questions cannot be fully considered if FINRA and the SEC do not have a full understanding of any shortcomings in risk assessment practices, including whether more stringent regulatory guidance might be appropriate.

Second, proposed subparagraph (c)(1)(B)(ii) should set forth certain minimum technological capabilities that firms must possess in order to conduct remote inspections under the pilot program. As proposed, subparagraph (c)(1)(B)(ii) states that "[t]hese tools may include but are not limited to," among other things, tools for electronic surveillance, activity-based sampling reviews, and visual inspections. (Emphasis added.) Technological capabilities such as these are critical to conducting "reasonable" inspections and should be a standard feature of all risk assessments. FINRA's December 15 letter responding to comments and detailing the Proposed

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[4] *Notice of Filing of a Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)*, SEC Rel. No. 34-95452, 16 (Aug. 9, 2022), *available at* https://www.sec.gov/rules/sro/finra/2022/34-95452.pdf.

Amendment (the "Response to Comments")[5] refers to commentary from the industry that suggests many firms already have and use these tools. As such, proposed subparagraph (c)(1)(B)(ii) should be revised to specify that the listed tools and capabilities constitute a mandatory floor for participants in the pilot program. While we understand that supervisory requirements are primarily principle-based, it is not inconsistent to establish defined floors for a principle-based standard. Indeed, the existing mandatory in-person inspection requirements are prescriptive floors underlying a principle-based standard of reasonable supervision. New prescriptive floors, tailored to a remote inspection regime, should be regarded as the minimum appropriate replacement safeguards.

II. Eligibility Conditions and Ineligibility Determinations

The Proposed Amendment would add further eligibility exclusions and conditions at both the firm and location levels in proposed subparagraph (c). These additions would help to ensure that firms and locations that present higher risks to investors would remain subject to in-person inspection requirements, thereby helping to protect investors from unnecessary risks. In particular, the proposed additional conditions in subparagraphs (c)(1)(B) and (c)(2)(B) are responsive to the concerns that we raised in our December 7 letter regarding a firm's access to and control over records. As such, NASAA supports these additions.

The Proposed Amendment also adds new subparagraph (k), which would establish the authority for FINRA to make a determination in the public interest and for the protection of investors that a firm is no longer eligible to participate in the pilot program. This amendment is also responsive to a suggestion that we made in our December 7 letter. However, proposed subparagraph (k) should be expanded to cover a broader range of circumstances than a narrow "fail[ure] to comply with the requirements of Rule 3110.18." Instead, it should provide FINRA with the ability to make such a determination if it finds that a firm "fails to comply with the requirements of applicable laws, rules, and regulations related to supervision of associated persons." This would help to ensure that FINRA's authority under subparagraph (k) is appropriately flexible to protect investors from misconduct and lax supervisory practices.

III. Written Supervisory Procedures and Effective Inspections

Consistent with our December 7 letter, we maintain that proposed Rule 3110.18 should define certain minimum requirements for firms' written supervisory procedures ("WSPs"). As explained in more detail in our December 7 letter, the pilot program should require that a firm's WSPs:

- articulate, with specificity, the technologies that the firm would be using for what purposes and provide evidence to show that the firm and its supervisory personnel have sufficient access to and proficiency with those technologies;

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[5] *See* Letter from Kosha Dalal, FINRA Vice President and Associate General Counsel, to Vanessa Countryman, Secretary, *Re: SR-FINRA-2022-021*, at 12, 15 (Dec. 15, 2022), *available at* https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021-20152889-320539.pdf.

- describe the circumstances in which the firm will conduct physical inspections, both in the ordinary course and as a result of risk indicators and red flags; and

- indicate whether the firm intends to conduct unannounced inspections, how the firm intends to do so remotely, and whether certain factors might influence the firm's decision to do so in particular circumstances.

Furthermore, a firm's WSPs should also describe how the firm will use its remote inspection procedures to control for the possibility of active deception. In our experience, in-person inspections are most effective because they provide a better ability to assess a person's demeanor and level of candor in ways that are harder to detect on the phone or during a videoconference. Regulators understand well how important it is to "diminish the opportunity for concealment, removal, or destruction of the evidence of misconduct" during inspections.[6]

FINRA acknowledges that a cycle inspection under Rule 3110(c) "is a singular event" occurring at a point in time.[7] As a result, it is important that a firm's inspection program be as robust as reasonably possible. Although Rule 3110 reflects a principle-based standard for "reasonable" supervision, including WSPs, it is not inconsistent with a principle-based approach to establish certain minimums or otherwise set boundaries around the principle. Contrary to FINRA's characterization of our earlier arguments, we do not oppose a principle-based standard.[8] Rather, we believe that it is important to set reasonable boundaries around the principle to ensure at least a minimum level of efficacy and investor protection. Our proposed minimum standards would not prescribe how a firm addresses the relevant issues in its WSPs; they would merely require that firms define their approaches to those issues.

IV. Pilot Program Data Collection

In our December 7 letter, we recommended certain changes to the timing and substantive scope of data collection under proposed Rule 3110.18. FINRA dismisses these recommendations in a footnote, stating that "the data and collection requirement, as proposed, will help in the effort to form effective practices in this area and assess the potential opportunity to modernize Rule 3110(c)."[9] The fundamental purpose of any pilot program is to gather data to determine an appropriate course of action. If the pilot program is approved, it should be designed to maximize the opportunity to collect data in order to fully inform policy discussions regarding such an important facet of investor protection. As such, we maintain that proposed Rule 3110.18 should be clearer and more specific about what information firms need to collect and how frequently they must provide that information to FINRA. Such specificity is necessary to ensure that FINRA can

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6 SEC, Staff Legal Bulletin No. 17, Remote Office Supervision (Mar. 19, 2004).

7 Response to Comments at 15.

8 *See id.* at 13.

9 *Id.* at 18.

supervise the pilot program appropriately, as well as to enable the SEC to conduct its own examinations of firms and oversee FINRA itself.

First, subparagraph (g) should be revised to require firms to provide FINRA with information about "all findings" made during remote inspections, not only the ones the firm subjectively deems "most significant." Leaving this element to the discretion of each individual firm will undermine the uniformity of the data, result in unequal reporting, and thus hinder FINRA's ability to fully assess trends and developments. The inherent subjectivity in the standard and the potential variability in the data is already clear from the comments of at least two firms that requested clarification of what FINRA means by "significant findings."[10] This standard is a moral hazard for firms inclined to inspect offices and locations superficially, and it would hamper FINRA's ability to identify supervisory lapses and insist on more rigorous supervision.

The proposed approach would also unnecessarily limit the data available to FINRA and the SEC after the pilot program has concluded, undermining a "key objective" of the proposal.[11] The pilot program should operate under the assumption that any finding is significant enough to be documented as such because it warrants review or corrective action. FINRA and the SEC need to have a complete understanding of trends such as what kinds of findings, if any, are increasing under remote inspections, as well as what kinds of findings are being discovered or noted less frequently. This would enable important follow-up questions about whether these trends are due to increased compliance, shortcomings in remote inspection practices, or some other cause. FINRA and the SEC will not be able to fully analyze the costs and benefits of potentially broader reliance on remote inspections if they do not have a complete picture of the costs. This is true even if certain costs are later determined to be acceptable, or even immaterial. Ultimately, a lack of robust data could prevent the SEC from determining that remote inspection practices should be ended or significantly curtailed in light of failures that would be evident from more comprehensive data – or could make it difficult for the SEC to get comfortable with expanding remote inspection practices after the pilot.[12]

Second, subparagraph (g) should require that firms deliver the information specified in the rule to FINRA on a set quarterly schedule. The proposed delivery frequency is not clearly defined and will likely result in data from different firms covering different time periods, thereby impeding comparability. A longer period, such as annual or twice-yearly, would likely hinder FINRA's ability to analyze the data effectively and attribute trends and changes to potential external factors,

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[10] *See id.* at 17-18. In addition to failing to define "significant finding" in proposed Rule 3110.18, FINRA does not explain how to determine whether a finding is one of the "most significant findings," rather than simply a "significant finding."

[11] *See id.* at 18-19.

[12] At minimum, FINRA should define "significant finding" in proposed Rule 3110.18 – *see*, *e.g.*, *id.* at 18 – and require firms to submit information about "all significant findings."

such as market shocks and anomalous events that may, for example, cause the number of customer complaints to rise.[13]

Finally, for the reasons detailed in our December 7 letter, firms should be required to provide FINRA with the information specified in proposed Rule 3110.18(g) covering the most recent 12-month period during which the firm conducted in-person inspections under Rule 3110(c). FINRA did not address this recommendation in its Response to Comments. This information is critical to a thorough assessment of the impact of remote inspections on firms' supervisory systems and investor protection.

V. Conclusion

In sum, the Proposed Amendment improves the proposed pilot program, and we appreciate FINRA's receptiveness to some of our concerns. Nonetheless, we continue to believe that additional guardrails, including those described above, are necessary before the pilot program can be considered appropriate for approval.

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,

Andrew Hartnett

Andrew Hartnett
NASAA President and
Deputy Commissioner,
Iowa Insurance Division

[13] This change becomes even more important if the SEC is inclined to approve the pilot program without modifying the standard for information about firms' inspection findings. The "most significant findings" will necessarily be determined relative to all other findings in a given data period. Thus, a non-uniform data delivery schedule could skew the available data by diluting the importance of each individual finding over longer periods. For example, a firm that delivers its data quarterly might provide information about findings that would not qualify as "most significant" relative to a broader pool of data collected by the firm over a period of twelve months.