

Alert | Financial Regulatory & Compliance



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FINRA Files Amendments to Proposed Rule Change That Will Allow Remote Inspections

Last summer, the Financial Regulatory Authority (FINRA) proposed a rule change to its supervision rule (FINRA Rule 3110) to allow member firms to conduct remote inspections of some or all branch offices and locations. This three-year pilot program would allow members to fulfill Rule 3110(c) obligations without on-site inspections. On Dec. 15, 2022, FINRA filed Partial Amendment No. 1 to add additional changes. The amendment responds to several comments received about the proposed rule. The SEC is set to approve or disapprove the proposed rule change some time in Q1.

The amendment covered six concerns, adding pertinent subparts to the proposed rule and a seventh amendment addressing other non-substantive or technical changes. First, FINRA proposes to amend Rule 3110.18(b) by adding a second subpart. This new paragraph (b)(2) includes factors firms must consider and document when conducting risk assessments. FINRA also proposes that firms should conduct on-site inspections or more consistent surprise on-site inspections of high-risk locations or sites with “red flags.” Because this change is based on commenter concerns that firms may not properly consider higher risk criteria when conducting risk assessments, FINRA’s expectation with these proposed changes is that after firms incorporate these factors, they are prompted to either establish or modify applicable compliance and supervisory policies and procedures.

The next several amendments are to FINRA Rule 3110.18(c). FINRA added subparts (1)(A)(iii)-(vi), proposing to exclude certain member firms along with their offices or locations from the proposed pilot

program. Exclusion would be based on whether firm or associated persons events or activities more likely raised investor protection concerns. Decisions would be based on FINRA's belief. The proposed amendment adds the following member event list:

- Receives a notice from FINRA under Rule 9557, Rule 4120, Rule 4110, or Rule 4130, unless FINRA has otherwise permitted activities in writing pursuant to such rule;
- Currently or becomes subject to FINRA suspension;
- FINRA membership effective within the prior 12 months (based on date in the Central Registration Depository (CID)); or
- Violated Rule 3110(c) within the past three years (finding from either the SEC or FINRA).

FINRA's intention is to limit the pilot program's potential member firm population to firms better positioned to conduct remote inspections and better maintain investor protection.

FINRA also added subpart (1)(B), adding new controls for books and records, surveillance, and technology tools for firms during pilot program participation. The intention is to establish reasonable baseline requirements for remote inspections and participating member firms must satisfy the following conditions to be eligible:

- Must have a recordkeeping system capable of making, maintaining, and preserving required records pursuant to applicable securities laws and regulations, FINRA rules, and the member firm's written supervisory procedures under Rule 3110;
- Records must not be physically or electronically maintained and preserved at the office/location subject to the remote inspection;
- Member has prompt access to the records; and
- Member must determine that its surveillance/technology tools are appropriate to supervise the risks presented by each applicable office/location.

Next, FINRA added subparts (2)(A)(v)-(vii) to expand the list of items to render member firms ineligible for remote inspections in hopes of strengthening the pilot program's terms:

- One or more associated persons at the office/location is/becomes subject to a mandatory heightened supervisory plan under SEC, FINRA or state regulatory agency rules;
- One or more associated persons at the office/location is/becomes statutorily disqualified, unless approved to associate with a member and not subject to a mandatory heightened supervisory plan under paragraph (c)(2)(A)(i) of its Supplementary Material or otherwise as a condition to approval/permission for such association;
- Firm is/becomes subject to Rule 1017(a)(7) due to one or more associated persons at the office/location; or
- One or more associated persons at the office/location has an event in the past three years requiring a "yes" response to any item in Questions 14A(1)(a) and 2(a), 14(B)(1)(a) and 2(a), 14(C), 14(D), and 14(E) on Form U4;
- One or more associated persons at the office/location is/becomes subject to a disciplinary action taken by the member that is/was reportable under Rule 4530(a)(2);

- One or more associated persons at the office/location is part of the member's trading desk (engages in market making activities, has authority to enter proprietary trades on behalf of the member or as agent for other parties); or
- The office/location handles customers' funds or securities.

FINRA adds subparts (2)(B)(i)-(iii) as the last proposed amendment to Rule 3110.18(c) – the following are three new eligibility conditions to conduct remote inspection during the pilot period:

- Electronic communications are made through the member's electronic system;
- The associated person's correspondence and communications with the public are subject to firm supervision, pursuant to Rule 3110; and
- No member books or records required under applicable securities laws and regulations, FINRA rules, and the member's written supervisory procedures under Rule 3110 are physically or electronically maintained/preserved at the office/location.

Finally, FINRA proposes to add subpart (k) to Rule 3110.18. This subpart would allow FINRA to determine that a member is no longer eligible to participate in the proposed pilot program if the member fails to comply with Rule 3110.18's requirements. When warranted, FINRA would provide written notice to the member alerting it to its ineligibility. The member would then have to resume on-site inspections.

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