SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-98980; File No. SR-FINRA-2023-006)

November 17, 2023

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, to Adopt Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110 (Supervision)

I. Introduction

On March 29, 2023, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change (SR-FINRA-2023-006) to adopt new Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110 (Supervision). The proposed rule change, as modified by Amendment Nos. 1 and 2 (hereinafter, the "proposed rule change" unless otherwise specified), would treat a private residence in which an associated person engages in specified supervisory activities, subject to certain safeguards and limitations, as a non-branch location.[3] Treated as non-branch locations, these newly defined Residential Supervisory Locations ("RSLs") would be subject to inspections on a regular periodic schedule (presumed to be at least every three years) instead of the annual inspection currently required for "offices of supervisory jurisdiction" ("OSJs") and "supervisory branch offices."[4]

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Exchange Act Release No. 97237 (Mar. 31, 2023), 88 FR 20568, 20568 (Apr. 6, 2023) (File No. SR-FINRA-2023-006 ("Notice") (citing FINRA Rules 3110(c)(1)(C) and 3110.13), https://www.govinfo.gov/content/pkg/FR-2023-04-06/pdf/2023-07145.pdf.

4 See id.

The proposed rule change was published for public comment in the Federal Register on April 6, 2023.[5] On May 16, 2023, FINRA consented to an extension of the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to July 5, 2023.[6] The Commission received thirteen comment letters in response to the Notice.[7]

On July 3, 2023, FINRA filed an amendment to the proposed rule change ("Amendment No. 1").[8] On July 5, 2023, the Commission published a notice of filing of Amendment No. 1 and an order instituting proceedings to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.[9] On July 25, 2023, FINRA responded to the comment letters received in response to the Notice.[10] The Commission received twelve comment letters in response to the notice of Amendment No. 1 and order instituting proceedings.

On September 14, 2023, FINRA responded to the comment letters received in response to the notice of Amendment No. 1 and order instituting proceedings, and it filed an amendment to the proposed rule change ("Amendment No. 2").[11] On September 22, 2023, FINRA consented to

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5 Id.

6 See letter from Sarah Kwak, Associate General Counsel, Office of General Counsel, FINRA, to Daniel Fisher, Branch Chief, Division of Trading and Markets, Commission, dated May 16, 2023, https://www.finra.org/sites/default/files/2023-05/sr-finra-2023-006-extension-no-1.pdf.

7 The comment letters are available at https://www.sec.gov/comments/sr-finra-2023-006/srfinra2023006.htm.

8 See Amendment No. 1, https://www.finra.org/sites/default/files/2023-07/sr-2023-006-amendment-No1.pdf.

9 Exchange Act Release No. 97839 (July 5, 2023), 88 FR 44173 (July 11, 2023) (File No. SR-FINRA-2023-006), https://www.govinfo.gov/content/pkg/FR-2023-07-11/pdf/2023-14523.pdf.

10 See letter from Sarah Kwak, Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated July 25, 2023 ("FINRA Response I"), https://www.sec.gov/comments/sr-finra-2023-006/srfinra2023006-235699-491502.pdf.

11 See Amendment No. 2, https://www.finra.org/sites/default/files/2023-09/SR-FINRA-2023-006-Amendment-2.pdf; letter from Kosha Dalal, Vice President and Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated Sept. 14, 2023 ("FINRA Response II"), https://www.sec.gov/comments/sr-finra-2023-006/srfinra2023006-259039-608182.pdf.

an extension of the time period in which the Commission must approve or disapprove the proposed rule change to December 2, 2023.[12] The Commission is publishing this order to provide notice of the filing of, and to solicit comments on, Amendment No. 2 from interested persons and is approving the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

II. Description of the Proposed Rule Change

FINRA stated that technological advancements and an emerging remote workplace prompted it to reconsider the regulatory framework for the supervision and inspection of residential locations.[13] As a result of this evaluation, FINRA determined to issue the proposed rule change "to create a regulatory framework in which member firms can capably continue to carry out their obligation to effectively inspect the supervisory activities taking place at an office or location . . . on a regular periodic schedule without diminishing investor protection."[14] After describing the current regulatory framework, the Commission describes the proposed rule change.

A. Background

1. FINRA Rule 3110 (Supervision)

FINRA Rule 3110 requires a member firm to establish and maintain a supervisory system for the activities of its associated persons "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules" (hereinafter, a

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12 See letter from Sarah Kwak, Associate General Counsel, Office of General Counsel, FINRA, to Daniel Fisher, Branch Chief, Division of Trading and Markets, Commission, dated Sept. 22, 2023, https://www.finra.org/sites/default/files/2023-09/sr-finra-2023-006-ext2.pdf.

13 Notice at 20569.

14 Id. at 20573.

"reasonably designed supervisory system").[15] The rule identifies the minimum requirements of a member's supervisory system, including: (1) the registration and designation as a branch office or an OSJ of each location,[16] including the main office, that meets the definitions contained in FINRA Rule 3110(f);[17] and (2) inspecting all offices and locations in accordance with Rule 3110(c).[18] The rule also establishes the frequency with which a member firm must inspect its locations.[19] The frequency is based, in part, on whether the location is designated as a supervisory branch office, a non-supervisory branch office, an OSJ, or a non-branch location.[20] Each of these designations is described in turn.

a. Supervisory and Non-Supervisory Branch Offices

FINRA Rule 3110(f)(2) defines a "branch office" as: (1) any location where one or more associated persons of a member regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security, or is held out as such;[21] or (2) 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.[22] A branch office is either

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[15] FINRA Rule 3110(a).

[16] Unless otherwise specified, the Commission uses the term "location" in this order to refer to any location where a firm does business, such as an OSJ, supervisory branch office, non-supervisory branch office, or non-branch location, as applicable.

[17] See FINRA Rule 3110(a)(3).

[18] See FINRA Rule 3110(c). On November 17, 2023, the Commission issued an approval order for File Number FINRA-2023-007, which adopted new Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision). FINRA Rule 3110.18 establishes a voluntary, three-year pilot program to allow eligible member firms to elect to fulfill their inspection obligations under FINRA Rule 3110(c) by conducting inspections of eligible OSJs, branch offices, and non-branch locations remotely without an on-site visit to such locations, subject to specified safeguards and limitations.

[19] See FINRA Rule 3110(c)(1).

[20] See id.

[21] FINRA Rule 3110(f)(2)(A).

[22] FINRA Rule 3110(f)(2)(B).

"supervisory" (i.e., it "supervises one or more non-branch locations") or "non-supervisory" (i.e., it "does not supervise one or more non-branch locations").[23] The branch office's type dictates the frequency of its inspection cycle: a supervisory branch office must be inspected at least annually,[24] and a non-supervisory branch office must be inspected at least every three years.[25]

b. Office of Supervisory Jurisdiction

A branch office may be further designated as an OSJ. An OSJ is any office of a member at which any one or more of the following functions take place: (1) order execution or market making; (2) structuring of public offerings or private placements; (3) maintaining custody of customers' funds or securities; (4) final acceptance (approval) of new accounts on behalf of the member; (5) review and endorsement of customer orders pursuant to Rule 3110(b)(2);[26] (6) final approval of retail communications for use by persons associated with the member pursuant to Rule 2210(b)(1), except for an office that solely conducts final approval of research reports;[27] or (7) having responsibility for supervising the activities of persons associated with the member at

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[23] See Notice at 20573 ("[A]ny 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 a branch office (i.e., a supervisory branch office)."); FINRA Rule 3110(c)(1)(B) ("Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations.").

[24] FINRA Rule 3110(c)(1)(A) ("Each member shall inspect at least annually . . . any branch office that supervises one or more non-branch locations.").

[25] FINRA Rule 3110(c)(1)(B) ("Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations.").

[26] FINRA Rule 3110(b)(2) provides that "[t]he supervisory procedures required by [Rule 3110(b) (Written Procedures)] shall include procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the investment banking or securities business of the member."

[27] "In general, with some exceptions, paragraph (b)(1) of Rule 2210 (Communications with the Public) requires that an appropriately qualified registered principal approve each retail communication prior to use or filing with FINRA." Notice at 20574 n.57.

one or more other branch offices of the member.[28] If a location satisfies any one of those criteria, it is an OSJ that must be inspected at least annually.[29]

c. Non-Branch Locations

FINRA explained that seven types of locations – often referred to as "unregistered offices" or "non-branch locations" – are excluded from the definition of "branch office."[30] Member firms must inspect their non-branch locations on a regular periodic schedule, presumed to be at least every three years.[31]

Two of the seven exclusions address residential locations: the primary residence exclusion and the non-primary residence exclusion. The primary residence exclusion[32] excludes from registration as a branch office any non-supervisory[33] location that is an associated person's primary residence, provided that: (1) only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location; (2) the location is not held out to the public as an office, and the associated person

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28 FINRA Rule 3110(f)(1).

29 See FINRA Rule 3110(c)(1)(A). In 1988, the National Association of Securities Dealers ("NASD," the predecessor to FINRA) stated that the amended OSJ definition, among other proposed amendments, focused on creating a "supervisory 'chain of command,' in which qualified supervisory personnel are appointed to carry out the firm's supervisory obligations . . . ." See Notice at 20572 (quoting NASD Notice to Members 88-11 (Feb. 8, 1988), https://www.finra.org/rules-guidance/notices/88-11).

30 See Notice at 20574; FINRA Rule 3110(f)(2)(A)(i)-(vii) (identifying seven exclusions from the definition of branch office).

31 See FINRA Rules 3110(c)(1)(C) (stating that "[i]n establishing such schedule, the member shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The member's written supervisory and inspection procedures shall set forth the schedule and an explanation regarding how the member determined the frequency of the examination.") and 3110.13 (stating that "[i]n establishing a non-branch location inspection schedule, there is a general presumption that a non-branch location will be inspected at least every three years, even in the absence of any indicators of irregularities or misconduct (i.e., "red flags"). If a member establishes a longer periodic inspection schedule, the member must document in its written supervisory and inspection procedures the factors used in determining that a longer periodic inspection cycle is appropriate.").

32 FINRA Rule 3110(f)(2)(A)(ii).

33 See supra note 23 and corresponding text.

does not meet with customers at the location; (3) neither customer funds nor securities are handled at that location; (4) the associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, retail communications, and other communications to the public by such associated person; (5) the associated person's correspondence and communications with the public are subject to the member firm's supervision in accordance with Rule 3110; (6) electronic communications (e.g., email) are made through the member's electronic system; (7) all orders are entered through the designated branch office or an electronic system established by the member that is reviewable at the branch office; (8) written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the member; and (9) a list of the residence locations is maintained by the member.[34]

The non-primary residence exclusion[35] excludes from registration as a branch office any non-supervisory location, "other than a primary residence, that is used for securities business for less than 30 business days in any one calendar year, provided [that] the member complies with" the conditions described in (1) through (8) of the primary residence exclusion (detailed above).[36] FINRA explained that the non-primary residence exclusion typically applies to a vacation or second home.[37]

Notwithstanding these residential exclusions, a private residence is considered a branch office if it "is responsible for supervising the activities of persons associated with the member at

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34 See FINRA Rule 3110(f)(2)(ii)(a) through (i).

35 FINRA Rule 3110(f)(2)(A)(iii).

36 Id.

37 See NASD Notice to Members 06-12 (Mar. 21, 2006), https://www.finra.org/rules-guidance/notices/06-12; see also Notice at 20574.

one or more non-branch locations of the member,"[38] and it is an OSJ if it performs any of the seven functions associated with OSJs.[39] Therefore, a primary or non-primary residence is subject to registration and annual inspection if the associated person's activities at the residence cause it to be an OSJ or supervisory branch office.[40]

2. FINRA's Stated Reasons for the Proposed Rule Change

FINRA stated that during the COVID-19 pandemic, many member firms developed "hybrid workforce models" in which "some employees may work permanently in an alternative location[,] such as a private residence, other employees may spend some time in alternative locations and some time on-site in a conventional office setting, and some may work on-site full time."[41] FINRA "believes this model will endure" notwithstanding the end of the COVID-19 Public Health Emergency in May 2023.[42] Many of the supervisors who began working from home during the pandemic continue to do so, at least on a part-time basis.[43] Under the current regulatory framework, those supervisors likely conduct activities that would require the registration and designation of their private residences as supervisory branch offices or OSJs

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38 FINRA Rule 3110(f)(2)(B).

39 FINRA Rule 3110(f)(1).

40 See FINRA Rules 3110(a)(3) and 3110(c)(1)(A).

41 Notice at 20579.

42 See Notice at 20569; Centers for Disease Control and Prevention, COVID-19: End of Public Health Emergency (PHE) Declaration (Sept. 12, 2023), https://www.cdc.gov/coronavirus/2019-ncov/your-health/end-of-phe.html.

43 See Notice at 20575 ("Firms responded that they relied extensively on technology to support their effective transition to the remote work environment and enhance the supervision of geographically dispersed associated persons, many of whom have been working from home since early 2020 and may continue to do so in some manner in the current environment."); FINRA Regulatory Notice 21-44 (Dec. 2021), https://www.finra.org/rules-guidance/notices/21-44 ("To mitigate the impacts of the pandemic, member firms have relied heavily on remote offices and alternative work arrangements (e.g., working from home or a backup or recovery location) for a broad range of personnel.").

under Rule 3110(a)(3) and thus would require inspections at least annually under Rule 3110(c)(1)(A).[44]

During the pandemic, FINRA temporarily suspended members' requirements to comply with the registration and inspection obligations applicable to new locations. Specifically, in March 2020, FINRA temporarily suspended the requirement for member firms to submit branch office registration applications on Form BR (Uniform Branch Office Registration Form) for any newly opened temporary office locations or space-sharing arrangements established because of the pandemic (the "Form BR Temporary Suspension").[45] The Form BR Temporary Suspension remains in effect. But when it ends, FINRA believes that current FINRA rules would require member firms to "either curtail activities at residential locations or register large numbers of residential locations as OSJs or supervisory branch offices."[46]

As set forth above, registering a private residence as an OSJ or supervisory branch office would trigger a corresponding annual inspection requirement.[47] FINRA explained that the proposed rule change would alter the regulatory framework to accommodate hybrid workforce models and mitigate the costs associated with registering and inspecting so many private residences.[48] FINRA stated that the proposed rule change "would allow firms to effectively and more efficiently carry out their supervisory responsibilities to review the activities of each office or location while preserving investor protections."[49]

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[44] See FINRA Rules 3110(a)(3) and 3110(c)(1)(A).

[45] See FINRA Regulatory Notice 20-08 (Mar. 2020) ("Regulatory Notice 20-08"), https://www.finra.org/rules-guidance/notices/20-08; see also Notice at 20569 n.7.

[46] See Notice at 20579.

[47] FINRA Rule 3110(c)(1)(A).

[48] Notice at 20575, 20579 (explaining that the proposed rule change would reduce, but not eliminate, the need to register and inspect residential locations as supervisory branch offices or OSJs).

[49] Id. at 20569.

B. The Proposed Rule Change

The proposed rule change would adopt new Supplementary Material .19 (Residential Supervisory Location) under FINRA Rule 3110 (Supervision) and would treat a private residence at which an associated person engages in certain supervisory activities as a non-branch location, subjecting it to inspections on a regular periodic schedule (presumed to be at least every three years) instead of the annual schedule required for OSJs and supervisory branch offices.[50] To help mitigate the potential risks associated with a less frequent inspection cycle, the proposed rule change also would establish safeguards that limit RSL designation to certain firms and locations based on criteria designed to minimize risk.[51] These safeguards would: (1) exclude certain member firms from designating any location as an RSL;[52] (2) exclude certain locations from designation as an RSL;[53] (3) impose certain conditions that a member firm and/or its candidate locations must meet prior to RSL designation;[54] (4) require any member firm that elects to designate an RSL to provide certain data to FINRA on a regular basis;[55] and (5) require any eligible member firm to develop a reasonable risk-based approach to designating a location as an RSL and conduct and document a risk assessment for the associated person assigned to that location prior to designating a location as an RSL.[56]

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50 See id. at 20568.

51 See id. at 20568-69 ("FINRA believes the proposal strikes an appropriate balance to preserve investor protection while developing a risk-based approach for designating residential supervisory locations that includes key safeguards with respect to, among other things, books and records of the member, while excluding locations where higher risk activities may take place or associated persons that may pose higher risk are assigned.").

52 See proposed Rule 3110.19(b).

53 See proposed Rule 3110.19(c).

54 See proposed Rule 3110.19(a).

55 See proposed Rule 3110.19(d).

56 See proposed Rule 3110.19(e).

1. Member Firm Ineligibility Criteria

Under proposed Rule 3110.19(b), a member firm would be ineligible to designate any of its locations as an RSL if the member: (1) is currently designated as a Restricted Firm under Rule 4111 (Restricted Firm Obligations) (hereinafter, a "Restricted Firm");[57] (2) is currently designated as a Taping Firm under Rule 3170 (Tape Recording of Registered Persons by Certain Firms) (hereinafter, a "Taping Firm");[58] (3) is currently undergoing, or is required to undergo, a review under Rule 1017(a)(7) as a result of one or more associated persons at such location (hereinafter, a "continuing membership review");[59] (4) receives a notice from FINRA pursuant to Rule 9557 (Procedures for Regulating Activities under Rule 4110 (Capital Compliance), Rule 4120 (Regulatory Notification and Business Curtailment), or Rule 4130 (Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties)), unless FINRA has otherwise permitted activities in writing pursuant to such rule;[60] (5) is or becomes suspended by FINRA (hereinafter, a "suspended firm");[61] (6) based on the date in the Central Registration Depository ("CRD"), had its FINRA membership become effective within the prior

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57 See proposed Rule 3110.19(b)(1).

58 See proposed Rule 3110.19(b)(2).

59 See proposed Rule 3110.19(b)(3). FINRA Rule 1017(a)(7) "requires a member firm to file an application for continuing membership 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." Notice at 20577 n.94 (citing FINRA Regulatory Notice 21-09 (Mar. 2021) (announcing FINRA's adoption of rules to address brokers with a significant history of misconduct)).

60 See proposed Rule 3110.19(b)(4).

61 See proposed Rule 3110.19(b)(5).

twelve months;[62] or (7) is or has been found within the past three years by the SEC or FINRA to have violated Rule 3110(c).[63]

FINRA stated that these exclusions address "attributes of a member firm that FINRA believes are more likely to raise investor protection concerns . . . ."[64] For example, FINRA explained that "a member firm that is experiencing issues complying with its capital requirements or that has been suspended by FINRA is more likely to face significant operational challenges that may negatively impact the firm's overall supervision of its associated persons."[65] Similarly, FINRA stated that "a firm that has been a FINRA member for less than 12 months is often still implementing its business plan and developing a supervisory system appropriate[ly] tailored to the firm's specific attributes and structure."[66] FINRA also stated that firms with recent Rule 3110(c) violations have "demonstrated challenges in developing or maintaining a robust inspection program."[67]

2. Location Ineligibility Criteria

A location of an otherwise eligible member firm[68] would be ineligible for RSL designation if one or more associated persons at the location: (1) is a designated supervisor who has less than one year of direct supervisory experience with the member, or an affiliate or subsidiary of the member that is registered as a broker-dealer or investment adviser;[69] (2) is

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62 See proposed Rule 3110.19(b)(6).

63 See proposed Rule 3110.19(b)(7).

64 Notice at 20576.

65 Id. at 20577.

66 Id.

67 Id.

68 Id. at 20578 ("Proposed Rule 3110.19 would not be available to a member firm or private residence that meets any of the ineligibility criteria in proposed paragraphs (b) or (c), respectively, under Rule 3110.19 even with the safeguards and limitations listed in proposed Rule 3110.19(a).").

69 See proposed Rule 3110.19(c)(1).

functioning as a principal for a limited period in accordance with Rule 1210.04 (Registration Requirements);[70] (3) is subject to a mandatory heightened supervisory plan under the rules of the SEC, FINRA, or a state regulatory agency;[71] (4) is statutorily disqualified, unless such disqualified person (A) has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member and (B) is not subject to a mandatory heightened supervisory plan under proposed Rule 3110.19(c)(3) or otherwise as a condition to approval or permission for such association;[72] (5) has an event in the prior three years that required a "yes" response to any item in Questions 14A(1)(a) and 2(a), 14B(1)(a) and 2(a), 14C, 14D, and 14E on Form U4 (Uniform Application for Securities Industry Registration or Transfer Registration) ("Form U4");[73] or (6) has been notified in writing that such associated person is now subject to any Investigation[74] or Proceeding,[75] as such terms are defined for Form U4, by the SEC, a self-regulatory organization, including FINRA, or state securities commission (or

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[70] See proposed Rule 3110.19(c)(2).

[71] See proposed Rule 3110.19(c)(3).

[72] See proposed Rule 3110.19(c)(4).

[73] See proposed Rule 3110.19(c)(5). Form U4's Questions 14A(1)(a), 14A2(a), 14B(1)(a), and 14B2(a) elicit reporting of criminal convictions, and Questions 14C, 14D, and 14E pertain to regulatory action disclosures. See Notice 20577 n.97.

[74] As defined for purposes of Form U4, an Investigation "[i]ncludes: (a) grand jury investigations; (b) U.S. Securities and Exchange Commission investigations after the 'Wells' notice has been given; (c) FINRA investigations after the 'Wells' notice has been given or after a person associated with a member, as defined by The FINRA By-Laws, has been advised by the staff that it intends to recommend formal disciplinary action; (d) NYSE Regulation investigations after the 'Wells' notice has been given or after a person over whom NYSE Regulation has jurisdiction, as defined in the applicable rules, has been advised by NYSE Regulation that it intends to recommend formal disciplinary action; (e) formal investigations by other SROs; or (f) actions or procedures designated as investigations by jurisdictions. The term investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, 'blue sheet' requests or other trading questionnaires, or examinations." FINRA, Form U4 Explanation of Terms at 2 (Apr. – Version 2014.1), https://www.finra.org/sites/default/files/AppSupportDoc/p468051.pdf.

[75] As defined for purposes of Form U4, a Proceeding is "[a] formal administrative or civil action initiated by a governmental agency, self-regulatory organization or a foreign financial regulatory authority; a felony criminal indictment or information (or equivalent formal charge), or a misdemeanor criminal information (or equivalent formal charge), but does not include an arrest or similar charge effected in the absence of a formal criminal indictment or information (or equivalent formal charge)." Id. at 3.

agency or office performing like functions) (each, a "Regulator") expressly 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 of 1933 ("Securities Act"), the Exchange Act, the Investment Advisers Act of 1940 ("Investment Advisers Act"), the Investment Company Act of 1940 ("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 or laws, or any of the rules of the Municipal Securities Rulemaking Board ("MSRB") or other self-regulatory organization, including FINRA.[76] Nonetheless, this sixth exclusion would permit an affected location to be designated or redesignated as an RSL upon the earlier of: (1) the member's receipt of written notification from the applicable Regulator that such Investigation has concluded without further action; or (2) one year from the date of the last communication from such Regulator relating to such Investigation.[77] This relief would not apply to an associated person subject to a covered Proceeding.[78]

FINRA stated that these exclusions "reflect the appropriate limitations on the private residences that can be designated" as an RSL.[79] For example, FINRA stated that "specified disclosures on Form U4 pertaining to criminal convictions[,] . . . final regulatory action[,] and the imposition of a mandatory heightened supervisory plan are indicia of increased risk to investors at some firms and locations . . . ."[80] FINRA further explained that requiring one-year of direct supervisory experience recognizes that "a new supervisor at the current member firm may need

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[76] See proposed Rule 3110.19(c)(6); Amendment No. 1.

[77] See id.

[78] See id.

[79] Notice at 20578.

[80] Id.

time to become knowledgeable about that firm's systems, people, products, and overall compliance culture," even if that new supervisor comes to the member firm with prior supervisory experience from another firm.[81] But FINRA also stated that affiliates and subsidiaries of FINRA members "may share systems and have similar compliance cultures to meet their obligations under federal securities laws."[82] For that reason, FINRA stated that the proposed rule change would "permit the one-year supervisory experience minimum to be satisfied by also counting supervisory experience accrued at an affiliate or subsidiary of the member firm that is registered as a broker-dealer or investment adviser."[83]

3. Conditions for Designation as a Residential Supervisory Location

The proposed rule change includes ten conditions that an eligible member firm and its eligible location must meet prior to designating the location as an RSL. Under proposed Rule 3110.19(a), a location that is the associated person's private residence where supervisory activities[84] are conducted would be considered a non-branch location, provided that: (1) only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location;[85] (2) the location is not held out to

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[81] Id.

[82] Amendment No. 1 at 5.

[83] Id. at 4.

[84] Proposed Rule 3110.19(a) indicates that the "supervisory activities" include "those described in Rule 3110(f)(1)(D) through (G) or in Rule 3110(f)(2)(B)." The supervisory activities identified in FINRA Rule 3110(f)(1)(D) through (G) include: final acceptance (approval) of new accounts on behalf of the member; review and endorsement of customer orders, pursuant to FINRA Rule 3110(b)(2); final approval of retail communications for use by persons associated with the member, pursuant to Rule 2210(b)(1), except for an office that solely conducts final approval of research reports; and, responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member. FINRA Rule 3110(f)(2)(B) addresses "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 . . . ."

[85] See proposed Rule 3110.19(a)(1).

the public as an office;[86] (3) the associated person does not meet with customers or prospective customers at the location;[87] (4) any sales activity that takes place at the location complies with the conditions set forth under Rule 3110(f)(2)(A)(ii) or (iii);[88] (5) neither customer funds nor securities are handled at that location;[89] (6) the associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, retail communications, and other communications to the public by such associated person;[90] (7) the associated person's correspondence and communications with the public are subject to the member firm's supervision in accordance with Rule 3110;[91] (8) the associated person's electronic communications (e.g., email) are made through the member's electronic system;[92] (9)(A) the member has a recordkeeping system to make, keep current, and preserve records required to be made, kept current, and preserved under applicable securities laws and regulations, FINRA rules, and the member's own written supervisory procedures under Rule 3110, (B) such records are not physically or electronically maintained and preserved at the office or location, and (C) the member has prompt access to such records;[93] and (10) the member has determined that its surveillance and technology tools are appropriate to supervise the types of risks presented by each RSL, and that these tools may include but are not limited to: (A) firm-wide tools, such as an electronic recordkeeping system, electronic surveillance of email and correspondence,

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86 See proposed Rule 3110.19(a)(2).

87 See proposed Rule 3110.19(a)(3).

88 See proposed Rule 3110.19(a)(4). Rule 3110(f)(2)(A)(ii) and (iii) identify the conditions for the primary and non-primary residence exclusions. For a discussion of those exclusions, see Section II(A)(1)(c) above.

89 See proposed Rule 3110.19(a)(5).

90 See proposed Rule 3110.19(a)(6).

91 See proposed Rule 3110.19(a)(7).

92 See proposed Rule 3110.19(a)(8).

93 See proposed Rule 3110.19(a)(9).

electronic trade blotters, regular activity-based sampling reviews, and tools for visual inspections, (B) tools specific to the RSL based on the activities of the associated person assigned to the location, products offered, and restrictions on the activity of the RSL, and (C) system tools, such as secure network connections and effective cybersecurity protocols.[94]

FINRA stated that these conditions "would strengthen a firm's ability to monitor the supervisory activities occurring at [an RSL] and act to lower the overall risks associated with such location . . . ."[95] FINRA explained that the first eight conditions are derived from those for the primary and non-primary residence exclusions, "which align with the SEC's Books and Records Rules [and] were developed in coordination with other [self-regulatory organizations] and state securities regulators."[96] For that reason, FINRA stated that member firms have "experience with monitoring and supervising these conditions."[97] FINRA coupled those eight conditions with a new books and records requirement and a condition addressing technology and surveillance tools.[98]

4. Obligation to Provide List of RSLs to FINRA

Under proposed Rule 3110.19(d), any member that elects to designate any location of the member as an RSL would be required to "provide FINRA with a current list of all locations designated as RSLs by the 15th day of the month following each calendar quarter in the manner and format (e.g., through an electronic process or such other process) as FINRA may

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94 See proposed Rule 3110.19(a)(10).

95 Notice at 20576.

96 Id.; see FINRA Rule 3110(f)(2)(A)(ii) and (iii).

97 Notice at 20576.

98 Id.

prescribe."[99] FINRA acknowledged that the CRD system[100] currently provides access to "information regarding the offices and locations (registered and unregistered) to which associated persons required to be registered are assigned," but it explained that "requiring member firms to affirmatively provide this information to FINRA through a scheduled process would make this information more readily accessible to regulators."[101]

5. Risk Assessment

Under proposed Rule 3110.19(e), a member would be required to "develop a reasonable risk-based approach to designating an office or location as an RSL[] and conduct and document a risk assessment for the associated person assigned to that office or location" prior to designating that location as an RSL (hereinafter, a "person-specific risk assessment").[102] The proposed rule change would require documentation of the factors considered, including, among others, whether the associated person at such office or location is now subject to: (1) customer complaints, taking into account the volume and nature of the complaints; (2) heightened supervision other than where such office or location is ineligible for RSL designation under proposed Rule 3110.19(c)(3); (3) any failure to comply with the member's written supervisory procedures; (4)

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99 Proposed Rule 3110.19(d). FINRA stated that it is "exploring ways to provide this information to state regulators in a practical format." Notice at 20578 n.108.

100 The CRD system is the central licensing and registration system used by the U.S. securities industry and its regulators. In general, information in the CRD system is obtained through the uniform registration forms that firms and regulatory authorities complete as part of the securities industry registration and licensing process. The uniform registration forms are Form BD (Uniform Application for Broker-Dealer Registration), Form BDW (Uniform Request for Broker-Dealer Withdrawal), Form BR (Uniform Branch Office Registration Form), Form U4, Form U5 (Uniform Termination Notice for Securities Industry Registration), and Form U6 (Uniform Disciplinary Action Reporting Form). These forms, particularly Forms U4 and U5, collect administrative, regulatory, criminal history, customer complaint, and other information about brokers, while Form BD collects similar information about broker-dealer firms. FINRA, state, and other regulatory authorities use this information in connection with their licensing and regulatory activities, and member firms use this information to help them make informed employment decisions. See Exchange Act Release No. 88760 (Apr. 28, 2020), 85 FR 26502, 26503 (May 4, 2020) (File No. SR-FINRA-2020-012).

101 Notice at 20578.

102 Proposed Rule 3110.19(e).

any recordkeeping violation; and (5) any regulatory communications from a Regulator indicating that the associated person at such office or location failed reasonably to supervise another person subject to their supervision, including but not limited to, subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations.[103] Furthermore, the proposed rule change would require the member to account for "any higher risk activities that take place [at] or a higher risk associated person that is assigned to that office or location."[104]

"Consistent with [a firm's] obligation under Rule 3110(a)," the proposed rule change also would provide that "the member's supervisory system must take into consideration any indicators of irregularities or misconduct (i.e., 'red flags') when designating an office or location as an RSL."[105] Further, the proposed rule change would provide that "[r]ed flags should . . . be reviewed in determining whether it is reasonable to maintain the RSL designation of such office or location in accordance with the requirements of [proposed Rule 3110.19] and [that] the member should consider evidencing steps taken to address those red flags where appropriate."[106]

III. Discussion and Commission Findings

After careful review of the proposed rule change, the comment letters, and FINRA's responses to the comments, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association.[107] Specifically,

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[103] Id.

[104] Id.

[105] Id.

[106] Id.

[107] In approving this rule change, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act, which requires, among other things, that FINRA rules 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.[108]

Pursuant to FINRA Rule 3110, member firms must "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."[109] Rule 3110 provides that "[e]ach member shall establish and maintain supervisory procedures that must 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'), etc."[110] Rule 3110(c) further requires member firms to conduct internal inspections of each location, and it identifies the presumed frequency of inspection for various types of locations.[111] Importantly, Rule 3110 provides that "[f]inal responsibility for proper supervision . . . rest[s] with the member."[112]

The proposed rule change is consistent with these obligations. It permits certain eligible firms to inspect certain eligible locations on a regular periodic schedule (presumed to be at least

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[108] 15 U.S.C. 78o-3(b)(6).

[109] FINRA Rule 3110(a).

[110] FINRA Rule 3110.12.

[111] FINRA Rule 3110(c)(1).

[112] See id. Rule 3110(a)(1) through (7) identify certain minimum requirements for the reasonably designed supervisory system. See generally FINRA Rule 3110.

every three years) instead of an annual schedule. If an eligible member firm and its eligible location comply with various conditions and safeguards – including a person-specific risk assessment – designed to minimize risks, the proposed rule change would provide this additional flexibility for the member firm in structuring its reasonably designed supervisory system. But it does not automatically transform residences into RSLs subject to less frequent inspection. Nor does it require firms to treat all residences where certain supervisory activities are performed as RSLs. It only permits a member firm to consider whether an RSL designation for a specific location would be appropriate in light of the rule's requirements and the member firm's broader obligation to establish and maintain a reasonably designed supervisory system. Accordingly, and as explained in more detail below, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Exchange Act.

A. Residential Supervisory Location Terms and Conditions

The proposed rule change has various terms and conditions that limit the RSL designation to certain firms and locations. The Commission addresses the terms and conditions, and any related comments, in turn.

1. Member Firm Ineligibility Criteria

As stated above, under proposed Rule 3110.19(b), a member firm would be ineligible to designate any of its locations as an RSL if the member is subject to any of seven firm-level eligibility exclusions. The seven exclusions address members that are designated as Restricted Firms under FINRA Rule 4111; members designated as Taping Firms under FINRA Rule 3170; members undergoing, or required to undergo, a continuing membership review under FINRA Rule 1017(a)(7) as a result of one or more associated persons at such location; firms that have received a notice from FINRA pursuant to FINRA Rule 9557, unless FINRA has otherwise

permitted activities in writing pursuant to such rule; firms suspended by FINRA; firms that have been FINRA members for less than one year; and firms that have been found within the past three years by the SEC or FINRA to have violated Rule 3110(c).[113]

One commenter specifically supported the inclusion of the firm-level exclusions covering suspended firms and firms that have been FINRA members for less than one year.[114] No commenter opposed any of the proposed seven firm-level eligibility exclusions.

FINRA reasonably determined to exclude a member firm from participation in the Pilot if the member firm is subject to any of the six proposed firm-level ineligibility criteria. Each of these criteria identifies – and excludes – member firms with characteristics that may indicate increased risk of non-compliance. Specifically, Restricted Firms have a history of misconduct or a high concentration of registered persons with a significant history of misconduct that gave rise to the designation,[115] while Taping Firms are subject to heightened regulatory oversight because they employ a "significant number of registered persons [who] previously worked for firms that have been expelled from the industry or have had their registrations revoked for inappropriate sales practices."[116] Moreover, a member firm that is required to undergo a continuing membership review pursuant to FINRA Rule 1017(a)(7) has a person at the proposed RSL who is seeking to become an owner, control person, principal, or registered person of the member firm who has, in the previous five years, one or more "final criminal matters" or two or more

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113 See supra notes 57 through 63 and accompanying text.

114 Theresa J. Manderski, SVP, Chief Compliance Officer – BD, Davenport & Company LLC, to the Commission, dated Apr. 27, 2023, at 2 ("Davenport").

115 Proposed Rule 3110.19(b)(1); see FINRA, Rule 4111 Frequently Asked Questions, https://www.finra.org/rules-guidance/key-topics/protecting-investors-from-misconduct/faq#:~:text=A%20Restricted%20Firm%20is%20a,such%20in%20a%20Department%20decision.

116 Proposed Rule 3110.19(b)(2); FINRA, FINRA Taping Rule (FINRA Rule 3170), https://www.finra.org/rules-guidance/guidance/taping-rule.

"specified risk events."[117] Finally, if the Commission or FINRA has found that a member firm has violated Rule 3110(c) within the past three years, the member firm has demonstrated a recent difficultly implementing a compliant inspection program.[118] Member firms covered by these exclusions therefore have a history of non-compliance or have registered representatives who have a history of (or come from a member firm with a history of) non-compliance. It is therefore reasonable for FINRA to determine that member firms that fall into these categories are not eligible to designate RSLs and exercise the flexibility that the proposed rule change provides in designing a member firm's supervisory system.

Furthermore, Rule 9557 notices are sent to member firms that are experiencing financial or operational difficulties.[119] Additionally, suspension of a member firm by FINRA would be based on FINRA's determination that the member firm has failed to comply with its regulatory requirements or suspension is needed for the safety of investors, creditors, or other members because of the member firm's financial or operational difficulties.[120] Such member firms raise concerns about their ability to comply with their obligations and may present risk to others. As

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[117] Proposed Rule 3110.19(b)(3) (exclusion applicable where the person responsible for triggering a continuing membership review is located at the proposed RSL); FINRA Rule 1017(a)(7). "The term 'final criminal matter' means a criminal matter that resulted in a conviction of, or plea of guilty or nolo contendere ('no contest') by, a person that is disclosed, or is or was required to be disclosed, on the applicable Uniform Registration Forms." FINRA Rule 1011(h). "Specified risk events" include certain investment-related, consumer-initiated (1) customer arbitration awards, (2) civil judgments, (3) customer arbitration settlements, or (4) civil litigation settlements. FINRA Rule 1011(p)(1), (2). "Specified risk events" also include certain investment-related civil actions or regulatory actions that result in (1) monetary sanctions for a dollar amount at or above $15,000 or (2) a bar, expulsion, revocation, recission, or suspension. See FINRA Rule 1011(p)(3), (4).

[118] Proposed Rule 3110.19(b)(7).

[119] Proposed Rule 3110.19(b)(4); see FINRA Rule 9557 (Procedures for Regulating Activities Under Rules 4110, 4120 and 4130 Regarding a Member Experiencing Financial or Operational Difficulties); see also FINRA Regulatory Notice 09-71 (Dec. 2009) (announcing SEC approval of consolidated FINRA rules governing financial responsibility), https://www.finra.org/rules-guidance/notices/09-71.

[120] Proposed Rule 3110.19(b)(5); A suspended firm may have been suspended because of a violation of "federal securities laws, rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or FINRA rules." FINRA Rule 8310(a)(3), (5); see FINRA Rule 9550 Series.

such, it is reasonable to conclude that these member firms should not be eligible for the proposed rule change that is designed to afford member firms greater flexibility in designing their supervisory systems.

Moreover, member firms that have been FINRA members for less than 12 months may need additional time to develop their supervisory and compliance systems to effectively comply with applicable securities laws and rules.[121] This time period also provides FINRA and other regulators with time to conduct inspections of new member firms to determine their compliance with their regulatory obligations before they may be eligible for the flexibility provided in the proposed rule.[122] It is therefore reasonable for FINRA to determine that firms must be operating for a certain amount of time before they can be eligible to designate RSLs. One year provides a reasonable balance between providing member firms with the flexibility for supervision allowed in the proposed rule and concerns that member firms need to develop experience operating before they are given such flexibility. In sum, these proposed exclusions limit RSL designation to certain member firms without indicia that their business operations, supervisory system, or inspection programs may lack the maturity or safeguards to fully address the potential risks associated with RSLs.[123]

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[121] Proposed Rule 3110.19(b)(6).

[122] See Exchange Act Rule 15b2-2, 17 CFR 240.15b2-2 (generally requiring inspection of a newly registered broker dealer within six months for compliance with applicable financial responsibility rules and within 12 months for all other applicable regulatory requirements).

[123] Cf. Exchange Act Release No. 90635 (Dec. 10, 2020), 85 FR 81540 (Dec. 16, 2020) (Order Approving File No. SR-FINRA-2020-011 to Address Brokers With a Significant History of Misconduct); Exchange Act Release No. 92525 (July 30, 2021), 86 FR 42925 (Aug. 5, 2021) and 86 FR 49589 (Sept. 3, 2021) (Corrected Order Approving File No. SR-FINRA-2020-041 to Adopt FINRA Rules 4111 (Restricted Firm Obligations) and 9561 (Procedures for Regulating Activities Under Rule 4111)).

2. Location Ineligibility Criteria

As stated above, proposed Rule 3110.19(c) would prohibit RSL designation for any location if one or more associated persons at the location is subject to any of six location-level eligibility exclusions.[124] These six exclusions address associated persons with less than one year of direct supervisory experience with the member or its affiliate or subsidiary, who are functioning as a principal for a limited period in accordance with Rule 1210.04 (Registration Requirements), who are subject to a mandatory heightened supervisory plan, who are statutorily disqualified, who are required to make disclosures about certain criminal and regulatory actions, or who are subject to a covered regulatory investigation or proceeding.[125] These six exclusions are discussed in more detail below.

a. Less Than One Year of Supervisory Experience

As originally proposed in the Notice, proposed Rule 3110.19(c)(1) would have prohibited an RSL designation for any location with a designated supervisor with less than one year of direct supervisory experience with the member firm.[126] Several commenters urged FINRA to eliminate this exclusion.[127] One commenter stated that requiring one year of supervisory experience is "not supported by any objective evidence and can only be characterized as arbitrary."[128] These commenters indicated that this proposed exclusion would negatively impact

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[124] Proposed Rule 3110.19(c).

[125] See supra notes 69 through 78 and accompanying text.

[126] Notice at 20577.

[127] Letters from Eversheds Sutherland LLP on behalf of the Committee of Annuity Insurers, to Secretary, Commission, dated Apr. 27, 2023, at 2 ("CAI"); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Secretary, Commission, dated Apr. 27, 2023, at 4-5 ("FSI"); Mark Quinn, Director of Regulatory Affairs, Cetera Financial Group, to Sherry Haywood, Assistant Secretary, Commission, dated Apr. 27, 2023, at 2-3 ("Cetera I"); Bernard V. Canepa, Managing Director & Associate General Counsel, Securities Industry and Financial Markets Association, to Vanessa Countryman, Secretary, Commission, dated Apr. 27, 2023, at 2 n.6 ("SIFMA I").

[128] Cetera I at 2.

the employment opportunities for "experienced supervisory personnel who may switch firms or those associated persons who are stand-outs at a firm [and secure a] promotion to a supervisory role."[129] Another commenter emphasized that "there is not a sufficient investor protection justification for this language to offset the substantial chilling effect on the transfer of experienced supervisory personnel from one broker-dealer to another broker-dealer."[130] Although one commenter acknowledged that a member firm could still permit a new supervisor to work from a residence registered as an OSJ or supervisory branch office in the first year, that commenter emphasized that this proposed exclusion would "create[] an additional burden that could have a disparate impact on people with years of experience who are reentering the workforce after time off to care for children or other family members."[131]

In the event that FINRA declined to delete the proposed exclusion, some commenters requested modifications to the provision instead.[132] For example, some commenters asked FINRA to modify the proposed exclusion to permit RSL designation for locations with supervisors who have as little as three months of direct supervisory experience with the member firm.[133] Alternatively, some commenters urged FINRA to permit RSL designation for

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[129] FSI at 4; see Cetera I at 2 ("Branches would be ineligible for classification as an RSL simply because individual supervisors who may have been employed by the member firm for many years but who have previously either performed functions not directly related to supervision were not formally designated as supervisors. In addition, branches that house supervisors who have a lot of experience in supervisory roles with other member firms but have been employed by the current member firm for less than one year would be ineligible for RSL status.").

[130] CAI at 2; see FSI at 4 ("this proposed criterion would place an unnecessary impediment on firms to hire and retain talent in a competitive job market."); Cetera I at 3 ("If a member firm wishes to hire a supervisor in a remote location, the arbitrary one-year requirement will prevent them from classifying their residence as an RSL for at least one year, which may prevent the firm from hiring the individual. [. . .] The benefits of this are minimal and do not outweigh the burdens.").

[131] FSI at 4.

[132] See FSI at 5; letter from Mark Seffinger, Chief Compliance Officer, LPL Financial, to Vanessa Countryman, Secretary, Commission, dated May 25, 2023, at 2 ("LPL I"); ASA 3.

[133] FSI at 5 (suggesting a "three or six-month requirement" if such a requirement remains in the proposed rule change); cf. Cetera I at 2 (suggesting that the time period "could as easily be three months or three years.").

supervisors with less than one year of supervisory experience with the member firm so long as the member firm conducts an inspection of the RSL within the first year of designation.[134]

In response, FINRA amended proposed Rule 3110.19(c)(1) to address "the comments about the potential adverse impacts [this condition] could have on hiring efforts."[135] As modified by Amendment No. 1, the proposed rule change would prohibit RSL designation for any location with a designated supervisor who has less than one year of direct supervisory experience with the member or an affiliate or subsidiary of the member that is registered as a broker-dealer or investment adviser.[136] FINRA explained that this modification would permit RSL designation for a location with a designated supervisor who has, for example, six months of supervisory experience with the member firm and six months of supervisory experience at the member's affiliate or subsidiary that is registered as a broker-dealer or investment adviser.[137] FINRA stated that this modification "recogniz[es] that such entities may share systems and have similar compliance cultures to meet their obligations under the federal securities laws."[138] As such, FINRA indicated that such supervisors should have sufficient experience with the member firm's compliance systems.[139]

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134 LPL I at 2 ("[W]e support a requirement for such [a] branch to be inspected within the first year of designation versus registering that location as an OSJ."); letter from Christopher A. Iacovella, President & Chief Executive Officer, American Securities Association, to Vanessa Countryman, Secretary, Commission, dated May 25, 2023, at 3 ("ASA") ("Rather than prohibiting new supervisors from taking advantage of the definition, we believe firms should be able to perform an onsite branch exam during the supervisor[']s first year.").

135 FINRA Response I at 5.

136 See proposed Rule 3110.19(c)(1); Amendment No. 1 at 4.

137 FINRA Response I at 5.

138 Id.

139 See id. at 4-5.

Five commenters supported the amended exclusion,[140] and one of them "agree[d] that this amendment strikes an appropriate balance between regulators' interest in high supervisory standards and industry concerns about the impact on hiring efforts."[141]

Three other commenters, on the other hand, opposed this proposed exclusion.[142] One of these three commenters repeated its request to remove this proposed exclusion, stating that it "is arbitrary and not reasonably related to the objectives it seeks to accomplish."[143] Another of these commenters preferred the exclusion as originally proposed in the Notice, explaining that FINRA erroneously assumes that the compliance and supervisory cultures are the same at all of a member's affiliates and subsidiaries.[144] The third commenter asked for a modification that would permit RSL designation so long as the associated person at the location has at least one

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140 Letters from Bernard V. Canepa, Managing Director & Associate General Counsel, Securities Industry and Financial Markets Association, to Vanessa Countryman, Secretary, Commission, dated Aug. 1, 2023, at 2 ("SIFMA II") (indicating that the modified language addresses "concerns raised by the industry"); Gail Merken, Chief Compliance Officer, Janet Dyer, Chief Compliance Officer, John McGinty, Chief Compliance Officer, Fidelity Investments, to Vanessa Countryman, Secretary, Commission, dated Aug. 1, 2023, at 1 ("Fidelity II"); Jim McHale, Executive Vice President, Head of WIM Compliance and Peter Macchio, Executive Vice President, Head of CIB Compliance, Wells Fargo, to Vanessa Countryman, Secretary, Commission, dated Aug. 1, 2023, at 2 ("Wells Fargo") (expressing appreciation for the amended proposal but encouraging a future reassessment "for experienced supervisors [who] are switching to a new supervisory role at an unaffiliated broker-dealer"); Jennifer Szaro, CRCP, Chief Compliance Officer, XML Securities, LLC, et al., to Vanessa Countryman, Secretary, Commission, dated July 29, 2023, at 1 ("XML") (the amended proposal "applies a commonsense approach, in that if an associated person has been working in either capacity the member will have a basis to evaluate the associated person's working relationship and conduct a reasonable risk assessment."); Andrew Hartnett, NASAA President and Deputy Commissioner, Iowa Insurance Division, North American Securities Administrators Association, Inc., to Sherry Haywood, Assistant Secretary, Commission, dated July 26, 2023, at 4 ("NASAA II").

141 NASAA II at 4.

142 Letters from Michael Friedman, Head of Broker Dealer, Albert Securities, LLC, to Vanessa Countryman, Secretary, Commission, dated July 24, 2023, at 1-2 ("Albert"); Mark Quinn, Director of Regulatory Affairs, Cetera Financial Group, to Vanessa Countryman, Secretary, Commission, dated July 31, 2023, at 2 ("Cetera II"); Hugh Berkson, President, Public Investors Advocate Bar Association, to Vanessa Countryman, Secretary, Commission, dated July 31, 2023, at 3 ("PIABA II").

143 Cetera II at 2 (stating that "[o]nce an individual passes the necessary qualifications examinations, they [should be able to] begin their duties immediately.").

144 PIABA II at 3 ("While some firms may share systems and have similar compliance cultures with affiliates and subsidiaries, many others [do not], especially given the size and complexity of numerous financial firms. Yet, FINRA's adjustment permits disparate entities to combine supervisory experience for meeting the one year minimum and contains no minimum time requirement at all for the member itself.").

year of any experience – either supervisory or non-supervisory – with the member, its affiliates, or its subsidiaries.[145]

In response, FINRA declined to further amend the proposed rule change.[146] FINRA stated that the amended language "appropriately addresses" the concern that this proposed exclusion is intended to address: that an associated person at an RSL might otherwise "not have the requisite tenure at the member firm to develop experience with the firm's systems, people, products, and overall compliance culture."[147]

The proposed rule change, as modified by Amendment No. 1 (requiring a level of supervisory experience to permit a member firm to consider an RSL designation), is reasonable. For new supervisors or supervisors hired from outside of a member firm's broader organization, the proposed rule change requires that they operate from a location that is an OSJ or supervisory branch office (where they would be inspected at least annually) for at least a year to gain supervisory experience with the member firm's systems and overall compliance culture.[148] Because of the unique nature of each member firm's business, FINRA reasonably determined that supervisors wishing to exercise the flexibility of this proposed rule change must first have experience with the member firm's systems and products, and fully integrate into a member firm's compliance program and culture. Therefore, just as it is reasonable for FINRA to exclude supervisors without *any* direct supervisory experience, it is also reasonable for FINRA to exclude

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145 Albert at 1-2 ("[U]nlike FINRA, we believe a newly-hired registered principal should be allowed to start the clock on their one year at their new employer by working remotely in a non-supervisory capacity prior to becoming a designated supervisor and qualifying their home as a residential supervisory location." . . . Doing so "would still require new employees to learn the details of their new firm before being eligible to supervise remotely . . . .").

146 FINRA Response II at 4-5.

147 Id.

148 See proposed Rule 3110.19(c)(1); supra notes 81 through 83 and accompanying text.

supervisors with substantial direct supervisory experience at different member firm(s). This proposed rule change does not, however, require these categories of excluded supervisors to work from a non-residential location. A member firm may permit such a supervisor to work from a residential location under the current regulatory framework by designating the new supervisor's residence as an OSJ or supervisory branch office and subjecting it to an annual inspection. The one-year time period – whether in a non-residential location or residential location designated as an OSJ or supervisory branch office – allows supervisors to develop experience with the member firm's systems, people, products, and overall compliance culture. This should help to ensure that new supervisors at a member firm develop the experience necessary to reasonably carry out their assigned supervisory responsibilities for a member firm's supervisory system before their residences become eligible for RSL designation and less frequent inspection.

It is reasonable for FINRA to determine that supervisors must have a certain amount of direct supervisory experience with the member firm, or an affiliate or subsidiary of the member that is registered as a broker-dealer or investment adviser, before their residence can be eligible for RSL designation. The one-year requirement will help ensure that new supervisors have an opportunity to gain experience with a member firm's systems and products, and fully integrate into a member firm's compliance program and culture. This time period also provides the member firm with time to evaluate the performance of the new supervisor to determine their compliance with their regulatory obligations before they may be eligible for the flexibility provided in the proposed rule. Moreover, one year provides a reasonable balance between providing member firms with the flexibility for supervision allowed in the proposed rule and

concerns that supervisors need to spend time directly supervising before they are given such flexibility.

Regarding the commenter's request to permit RSL designation so long as the associated person at the proposed RSL has at least one year of *any* experience with the member firm, its affiliates, or its subsidiaries,[149] it is reasonable for FINRA to conclude that supervisors without direct supervisory experience at the member firm, its affiliates, or its subsidiaries may lack the skills and experience to effectively supervise other people, locations, and business activities from a residence treated as a non-branch location. For that reason, it is reasonable that FINRA limited qualifying experience to direct supervisory experience with the member firm, its affiliates, or its subsidiaries.

Commenters expressed concern that this proposed exclusion would negatively impact hiring and retention without providing an investor-protection benefit.[150] However, member firms retain the flexibility to permit supervisors to work from a residential location registered as an OSJ or supervisory branch office. Firms may choose to exercise that flexibility to attract and retain talent, and the proposed rule change would provide member firms even more flexibility after the supervisor has gained at least one year of supervisory experience with the member firm. In light of these factors, it is reasonable to require new supervisors or supervisors new to the member firm to work from a location registered as an OSJ or supervisory branch office that would be subject to an annual inspection cycle for a set period of time.

A commenter opposed the provision providing that the one-year experience requirement may be satisfied by experience with a member firm's affiliate or subsidiary that is registered as a

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149 Albert at 1-2.

150 See FSI at 4, CAI at 2, Cetera I at 2-3.

broker-dealer or investment adviser.[151] This commenter explained that member firms, affiliates, and subsidiaries do not necessarily share the same compliance systems and cultures.[152] However, where a member firm relies on a supervisor's experience from an affiliate or subsidiary to satisfy the experience requirement, the supervisor's private residence would not be automatically designated as an RSL. Rather, as discussed further below, proposed Rule 3110.19(e) would require the member firm to conduct and document a person-specific risk assessment prior to designating the location as an RSL. If a supervisor lacks comparable supervisory experience with the member, its affiliates, or its subsidiaries, or if the member, its affiliates, or its subsidiaries do not have similar compliance systems and cultures, the member firm may choose to consider those circumstances to assess whether such an RSL designation is appropriate.

b. Heightened Supervisory Plans

As stated above, proposed Rule 3110.19(c)(3) would prohibit RSL designation for any location with a designated supervisor who "is subject to a mandatory heightened supervisory plan under the rules of the SEC, FINRA, or a state regulatory agency."[153] One commenter urged FINRA to modify this proposed exclusion to also cover "heightened supervision under a plan established by the member in connection with or in response to any such regulator's recommendation or finding," stating that the rule should not distinguish between heightened supervisory plans imposed by regulators and those imposed by member firms.[154] The

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[151] PIABA II at 3.

[152] See id.

[153] See proposed Rule 3110.19(c)(3).

[154] See letter from Andrew Hartnett, NASAA President and Deputy Commissioner, Iowa Insurance Division, North American Securities Administrators Association, Inc., to Sherry Haywood, Assistant Secretary, Commission, dated April 27, 2023, at 4-5 ("NASAA I").

commenter explained that a member firm's decision to impose its own heightened supervisory plan "in lieu of a formal regulatory action or order[] or in response to a regulatory examination" raises "the same concerns as regulator-mandated plans and should be addressed accordingly."[155]

In response, FINRA declined to extend the proposed exclusion to cover any heightened supervisory plans imposed by a member.[156] FINRA expects that a member may, from time to time, impose voluntary heightened supervisory plans as part of its supervision program.[157] FINRA stated that what constitutes a firm-imposed heightened supervisory plan is "subjective," and it expressed concern that extending this proposed exclusion to them "could act to disincentivize firms from imposing tailored or more specific supervisory controls if the result [would be] RSL ineligibility."[158] However, FINRA "agree[d] that there is value in considering heightened supervision as a risk factor."[159] To balance the commenter's concern with FINRA's concern about discouraging the use of heightened supervision, FINRA modified the proposed rule change to require consideration of non-mandatory heightened supervisory plans in the risk assessment described in proposed Rule 3110.19(e).[160]

The same commenter characterized FINRA's modification as "an acceptable balance between [its previous] concerns and FINRA's desire not to disincentivize firms from taking such

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155 Id. at 5.

156 FINRA Response I at 6.

157 Id. ("[A] firm should routinely evaluate its supervisory system to ensure it is appropriately tailored to the firm's business. Such an evaluation may prompt a firm, out of an abundance of caution and independent of specific regulatory requirements or mandates, to undertake additional supervisory measures, including voluntarily imposing a heightened supervisory plan.").

158 Id.

159 Id.

160 Id.; see proposed Rule 3110.19(e).

steps to proactively improve their supervisory systems."[161] No commenter opposed the amended language.

Prohibiting locations with an associated person subject to a regulator-imposed heightened supervisory plan from being designated as an RSL is reasonable as it is designed to limit compliance risks. If a regulator has imposed a heightened supervisory plan on a specific associated person, the regulator has determined that they require additional supervision to help ensure their compliance with securities laws, regulations, and rules. It is reasonable for FINRA to determine that under those circumstances a member firm should not be permitted to designate that person's residence as an RSL and permit a reduced inspection cycle. Firm-imposed heightened supervisory plans may, in some circumstances, indicate similar risks. At the same time, expanding this exclusion to firm-imposed supervisory plans could disincentivize firms from using heightened supervision when circumstances would otherwise counsel such a plan. Under these circumstances, it is reasonable to require member firms to consider any firm-imposed heightened supervisory plans as part of the mandatory, person-specific risk assessment.

c. Investigations and Proceedings Alleging a Failure to Supervise

As originally proposed in the Notice, proposed Rule 3110.19(c)(6) would have prohibited RSL designation for any location with an associated person who is "currently subject to, or has been notified in writing that [they] 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,

161 NASAA II at 4.

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 or laws, or any of the rules of the MSRB or FINRA."[162]

Three commenters supported this proposed exclusion.[163] One commenter emphasized the importance of equal treatment for all regulatory actions alleging a failure to supervise, regardless of whether federal or state securities laws are at issue.[164] Another commenter coupled its support with a recommendation that the proposed exclusion also extend to associated persons who have been subject to multiple customer complaints, arbitrations, and civil cases.[165]

Four commenters opposed the proposed exclusion, citing practical challenges associated with the tracking, duration, and resolution of state-level securities investigations.[166] In particular, three of the opposing commenters stated that the inclusion of state-law violations in this proposed exclusion is fundamentally unfair, and one of these commenters stated that supervisors would "lose[] the privilege of workplace flexibility for an uncertain and inordinate amount of time[, disrupting their lives] without any adjudication that they failed in their supervisory

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162 Notice at 20577; proposed Rule 3110.19(c)(6).

163 NASAA I at 2; letter from Hugh Berkson, President, Public Investors Advocate Bar Association, to Vanessa Countryman, Secretary, Commission, dated Apr. 26, 2023, at 3 ("PIABA I"); Davenport at 2 (supporting "[m]aking an office or location ineligible when an associate[d] person is [the] subject of an investigation or action relating to a failure to supervise.").

164 NASAA I at 2 ("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.").

165 PIABA I at 3.

166 ASA at 2; Cetera I at 3-4; letter from Scott C. Kursman, Managing Director & Chief Compliance Officer, Citigroup Global Markets, Inc., to Vanessa Countryman, Secretary, Commission, dated Apr. 28, 2023, at 1-2 ("Citigroup"); SIFMA I at 1-3. Taken together, the alleged practical challenges include: state investigations are difficult to track; state investigations may take years to commence or conclude; it is difficult to discern when state investigations commence or conclude; state regulators open investigations based on varying standards for the evidence required to open such an investigation; and the phrase "subject of" is too vague to equip firms to effectively comply with the proposed exclusion. See SIFMA I at 1-3; Citigroup at 1 (noting that it shares SIFMA's concern); ASA at 2 (taking this position in comments related to the "Pilot Program"); Cetera at 3-4.

duties."[167] For these reasons, three opposing commenters urged FINRA to remove state-level securities investigations from the proposed rule change.[168] The fourth opposing commenter similarly recommended that FINRA narrow the proposed exclusion such that it take effect upon receipt of something akin to a Wells notice.[169]

In response, FINRA amended the proposed exclusion in two ways.[170] First, FINRA limited its scope to Investigations and Proceedings, as those terms are defined in Form U4, by a Regulator "expressly" alleging a failure to supervise.[171] FINRA stated that "using the definitions from Form U4 provides consistency and clarity not only with respect to the scope of applicable

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167 SIFMA I at 3; see Citigroup at 1 ("[T]he fact that the mere initiation of an investigation, as opposed to some adjudicated finding, can be the basis for ineligibility seems problematic from an individual fairness and notice standpoint."); Cetera at 4 ("It unfairly shifts the presumption from innocence to guilt without any form of substantive finding, much less adjudication.").

168 SIFMA at 3; Citigroup at 1 ("We support the suggestion made by SIFMA that, rather than lose RSL eligibility, a state investigation for failure to supervise should be considered by a firm's preexisting obligations under Rule 3110 to maintain a reasonably designed supervisory system and to conduct an appropriate risk assessment."); ASA at 2 ("We implore federal regulators not to allow unsubstantiated claims by state regulators trying to protect their regulatory turf to dictate how the regulation of the modern broker-dealer business should evolve.").

169 Cetera I at 4 ("RSL eligibility would only be precluded if the associated person has been notified by a regulatory agency, in writing, that the agency intends to take or recommend enforcement action against the individual for failure to perform supervisory responsibilities."). A Wells notice is a communication from SEC Staff to a person involved in an investigation that: (1) informs the person the staff has made a preliminary determination to recommend that the Commission file an action or institute a proceeding against them; (2) identifies the securities law violations that the staff has preliminarily determined to include in the recommendation; and (3) provides notice that the person may make a submission to the Division and the Commission concerning the proposed recommendation. See Enforcement Manual, Securities and Exchange Commission, Division of Enforcement, at 19-20, https://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

170 See FINRA Response I at 6-9; proposed Rule 3110.19(c)(6); Amendment No. 1.

171 FINRA Response I at 7-8; see Amendment No. 1; proposed Rule 3110.19(c)(6). As modified by Amendment No. 1, the proposed rule change would prohibit RSL designation for any location with an associated person who "has been notified in writing that [he or she] is now subject to[] any Investigation or Proceeding, as such terms are defined [for Form U4], by [a Regulator] expressly 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 [a]cts or laws, or any of the rules of the MSRB or other self-regulatory organization, including FINRA." Proposed Rule 3110.19(c)(6). The proposed amendment also broadens the scope of the applicable rules. As originally proposed in the Notice, the proposed rule change would have reached the rules of the MSRB and FINRA, but not – as now proposed – "any" self-regulatory organization. See Notice at 20577.

events subject to the ineligibility criteria, but also regarding when some events "begin" (e.g., after the 'Wells' notice has been given)."[172] Second, FINRA included a temporal element to provide that such locations may be designated or redesignated as an RSL subject to the requirements of the proposed rule change, as modified by Amendment No. 1, upon the earlier of: (1) the member's receipt of written notification from the applicable Regulator that such Investigation has concluded without further action; or (2) one year from the date of the last communication from such Regulator relating to such Investigation.[173] FINRA explained that the proposed amendment addresses "commenters' concerns that unadjudicated allegations would form the basis of a location's permanent exclusion as an RSL."[174]

Three commenters supported the modified exclusion, stressing that the revisions provide regulatory clarity and address industry concerns about the uncertain length of some regulatory investigations.[175] A fourth commenter "generally support[ed]" the modified provision because it "reduces the likelihood that a location remains ineligible for longer than reasonably necessary for a regulator to investigate potential misconduct[] while allowing regulators sufficient flexibility to

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172 FINRA Response I at 8-9. FINRA emphasized that this proposed exclusion would apply "where a Regulator's written notification to an associated person describes circumstances and other allegations that could be reasonably construed to relate to a failure to reasonably supervise another individual under the associated person's supervision." Id. at 8.

173 See FINRA Response I at 6-9; Proposed Rule 3110.19(c)(6); Amendment No. 1. As stated above, this proposed modification would not apply to an associated person who is subject to an ongoing Proceeding.

174 FINRA Response I at 9.

175 SIFMA II at 2 ("[T]he Proposed Rule Change, as amended, addresses in part concerns raised by the industry. For example, proposed Rule . . . 3110(c)(6) now allows a firm to designate or redesignate an RSL location after a specified period of time following an investigation."); XML at 1 (the use of the Form U4 definitions for Investigation and Proceeding "will maintain consistency within the industry," and the revised exclusion "will enable members to determine an effective date for designation or redesignation of an RSL"); Fidelity II at 2 ("Fidelity also appreciates the clarification provided concerning an associated person who is the subject of an investigation or proceeding by a regulator, particularly the ability to resume designating a location as an RSL either at the closure of the proceeding or after the matter has been idle for a year.").

conduct a thorough investigation."[176] But this commenter asked for further modifications to broaden the scope of the proposed rule change, including to codify FINRA's statement that the exclusion would apply where circumstances can be reasonably construed to evidence a covered Investigation, to clarify that a Wells notice or its equivalent "is not a prerequisite for ineligibility under this criterion," and to clarify that some regulatory communications, including subpoenas, may provide notice of a covered investigation "depending on the information" they contain.[177]

In response, FINRA declined to further amend the proposed rule change.[178] FINRA stated that "the well-established definitions from Form U4 provide a clear picture of the scope of applicable events subject to the proposed eligibility criterion."[179] FINRA also emphasized that although subpoenas and other regulatory communications do not necessarily establish the existence of an "Investigation" as defined in Form U4, the proposed rule change separately requires firms to consider "any regulatory communications," including subpoenas, in the mandatory risk assessment.[180]

The proposed rule change, as modified by Amendment No. 1, reasonably addresses the potential risks indicated by written communications from a Regulator alleging a failure to supervise. It is reasonable for FINRA to conclude that, where an associated person's conduct has resulted in a Regulator notifying the associated person that they are subject to an Investigation or a Proceeding expressly alleging that they have failed reasonably to supervise another person subject to their supervision, the potential risk warrants the associated person

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176 NASAA II at 2-3.

177 Id. at 3-4 and n.8.

178 FINRA Response II at 6.

179 Id.

180 See id.

having their residence inspected on a more frequent basis, and therefore the residence should not be designated as an RSL.[181]

The proposed exclusion, as modified by Amendment No. 1, also reasonably addresses commenter concerns with its scope and equips member firms to comply with its terms. By limiting its scope to certain Investigations and Proceedings, as those terms are defined for purposes of Form U4, that "expressly" allege a failure to reasonably supervise, the proposed exclusion clarifies that FINRA does not expect firms to discern – based on vague or ambiguous information – whether the exclusion applies. Separately, the proposed rule change addresses commenter concerns that unadjudicated allegations might permanently prohibit a location from RSL designation by including a temporal element that permits the designation or redesignation of affected RSLs under limited circumstances. Specifically, this provision would permit RSL designation or redesignation upon (1) the member's receipt of written notification from the applicable Regulator that such Investigation has concluded without formal action or (2) one year from the date of the last communication from such Regulator relating to such Investigation.[182] Finally, while the proposed exclusion would not capture circumstances short of a formal Investigation or Proceeding that could counsel against an RSL designation, the proposed rule change separately requires firms to consider – as part of the mandatory, person-specific risk assessment – any regulatory communications from a Regulator indicating that the associated

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[181] NASAA requested that FINRA clarify that a Wells notice or its equivalent "is not a prerequisite for ineligibility under this criterion." NASAA II at 3. The proposed rule change, as modified by Amendment No. 1, makes clear that "Investigation" has the same meaning as it does for Form U4. See supra note 74 and accompanying text. For purposes of Form U4, some of the circumstances constituting an "Investigation" would not require a Wells notice. See id.

[182] Proposed Rule 3110.19(c)(6).

person at the proposed RSL failed reasonably to supervise another person subject to their supervision.[183]

d. Customer Complaints, Arbitration Claims, and Civil Actions

As originally proposed in the Notice, proposed Rule 3110.19(c) did not include a location-level exclusion addressing any associated person who is or has been subject to multiple customer complaints or customer-initiated, investment-related arbitration claims or civil actions.[184] One commenter recommended that FINRA include a location-level exclusion covering such associated persons, as these customer-initiated actions are often the "canary in the coal mine" indicating threats to investor protection.[185] In response, FINRA modified the proposed rule change (as described in more detail below) to require a member to consider the volume and nature of customer complaints as part of the mandatory, person-specific risk assessment prior to RSL designation.[186] Although the proposed risk assessment does not expressly require the consideration of customer-initiated, investment-related arbitration or civil litigation, FINRA emphasized that the risk assessment's list of factors is "non-exhaustive" and it "agree[d] that the presence of such arbitration[s] or civil litigation[s] would be a factor for a firm to consider as part of the risk assessment."[187]

In response to the Amendment No. 1, the commenter repeated its request that the location-level exclusions also cover locations of associated persons who have been subject to multiple customer complaints or customer-initiated, investment-related arbitrations or civil

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183 Proposed Rule 3110.19(e)(5).

184 See Notice at 20577-78; proposed Rule 3110.19(c).

185 PIABA I at 3.

186 Proposed Rule 3110.19(e); Amendment No. 1 at 6.

187 FINRA Response I at 7.

actions.[188] This commenter emphasized that such an associated person should be disqualified from working from an RSL "[r]ather than trusting member firms to conduct and document a risk assessment[] that includes examining the 'volume and nature of customer complaints.'"[189]

In response, FINRA declined to modify the proposed rule change to include an automatic exclusion for locations with associated persons who have been the subject of multiple customer complaints.[190] FINRA emphasized that customer complaints "may lack merit," and the proposed rule change's mandatory risk assessment requires the consideration of the volume and nature of customer complaints prior to any RSL designation.[191]

The proposed rule change takes a reasonable approach to the issue of customer complaints and customer-initiated, investment-related arbitration claims and civil actions by requiring firms to consider the "volume and nature of customer complaints" in the mandatory risk assessment prior to RSL designation.[192] Although the proposed risk assessment does not explicitly mandate the consideration of customer-initiated, investment-related arbitration claims and civil actions, the risk assessment's factors are non-exhaustive. Moreover, FINRA has stated that such arbitration claims and civil actions would be relevant factors for consideration during the mandatory risk assessment.[193]

Such complaints, claims, and actions may, in certain circumstances, indicate heightened levels of risk. However, they are not formal investigations or proceedings initiated by a regulator charged with enforcing securities laws, regulations, and rules. For example, they may

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188 PIABA II at 3-4.

189 Id. at 4.

190 See FINRA Response II at 6.

191 Id.

192 The Commission addresses the proposed risk assessment in Section III(A)(5).

193 FINRA Response I at 7.

be overly broad in scope or lack the factual development of a comparable regulatory action. Because assessing the risk associated with complaints, claims, and actions may require investigation and a consideration of the totality of the circumstances, it is reasonable that – in lieu of creating a blanket exclusion for such associated persons – the volume and nature of customer complaints should be considered in the mandatory risk assessment.

e. Other Three Location-Level Exclusions

As stated above, the proposed rule change's location-level eligibility exclusions also prohibit RSL designation for any location with an associated person who: (1) is functioning as a principal for a limited period in accordance with Rule 1210.04 (Registration Requirements); (2) is statutorily disqualified, unless such disqualified person (A) has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member and (B) is not subject to a mandatory heightened supervisory plan under proposed Rule 3110.19(c)(3) or otherwise as a condition to approval or permission for such association; or (3) has an event in the prior three years that required a "yes" response to any item in Questions 14A(1)(a) and 2(a), 14B(1)(a) and 2(a), 14C, 14D, and 14E on Form U4.[194] No commenter offered specific support for, or opposition to, any of these three exclusions.

Each of these three location-level exclusions is reasonable in light of the increased risk each category of person might pose. First, a supervisor acting as a principal for a limited period prior to passing a qualification examination has not yet acquired the credentials allowing them to act as a principal on a permanent basis.[195] Second, an individual subject to a statutory

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194 See proposed Rule 3110.19(c)(2), (4), and (5).

195 FINRA Rule 1210.04 permits a member to "designate any person currently registered, or who becomes registered, with the member as a representative to function as a principal for a period of 120 calendar days prior to passing an appropriate principal qualification examination as specified under Rule 1220(a), provided that such person has at least 18 months of experience functioning as a registered representative

disqualification has engaged in violative conduct that may indicate an increased risk of non-compliance.[196] Third, an individual with certain regulatory or criminal-action disclosures on Form U4 has a history of criminal conviction(s) or regulatory finding(s) that may indicate an increased risk of non-compliance.[197] Because of the heightened risks associated with these three categories of supervisors, it is reasonable for the proposed rule change to require such supervisors to operate from an OSJ or supervisory branch office (where they will be inspected at least annually) rather than from a location designated as an RSL (where they would be inspected on a regular periodic schedule, presumed to be at least every three years).[198] Therefore, it is reasonable to exclude such supervisors' residences from RSL designation.

3. Conditions for Designation as a Residential Supervisory Location

As stated above, proposed Rule 3110.19(a) would provide that an associated person's private residence where supervisory activities are conducted may be eligible for RSL designation provided that the member firm and/or location complies with ten conditions.[199] FINRA stated that it adapted the first eight conditions from the primary and non-primary residence

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within the five-year period immediately preceding the designation and has fulfilled all applicable prerequisite registration, fee and examination requirements prior to designation as a principal. However, in no event may such person function as a principal beyond the initial 120 calendar day period without having successfully passed an appropriate principal qualification examination as specified under Rule 1220(a)."

196 Section 3(a)(39) of the Exchange Act identifies a list of events that disqualify someone from membership in, participation in, or association with a member of a self-regulatory organization. 15 U.S.C. 78c(a)(39).

197 See supra note 73.

198 See FINRA Rule 3110(c)(1); proposed Rule 3110.19(a).

199 See proposed Rule 3110.19(a). SEB Securities stated that the proposed rule change "does not fully explain how often a home office would need to be used to be considered a non-branch location or RSL" and questioned whether the RSL designation is "only for associated persons whose primary place of business is their home." Letter from Anonymous, Compliance Officer, SEB Securities, Inc. ("SEB"), to the Commission, dated July 13, 2023. FINRA responded that SEB's comment relates to a "broader question about the branch office definition" and that the proposed rule change "is not intended to change" the longstanding definition of "branch office," which has been in effect since 2006. FINRA Response II at 8.

exclusions.[200] It added a ninth condition on recordkeeping and a tenth condition addressing technology and surveillance tools.[201] These ten conditions are discussed in more detail below.

a. Conditions Adapted from the Primary and Non-Primary Residence Exclusions

As stated above, FINRA adapted the first eight conditions of the proposed rule change from the primary and non-primary residence exclusions: (1) only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location;[202] (2) the location is not held out to the public as an office;[203] (3) the associated person does not meet with customers or prospective customers at the location;[204] (4) any sales activity that takes place at the location complies with the conditions set forth under Rule 3110(f)(2)(A)(ii) or (iii);[205] (5) neither customer funds nor securities are handled at that location;[206] (6) the associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, retail communications, and other communications to the public by such associated person;[207] (7) the associated person's correspondence and communications with the public are subject to the

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200 Notice at 20576.

201 Id.

202 See proposed Rule 3110.19(a)(1).

203 See proposed Rule 3110.19(a)(2).

204 See proposed Rule 3110.19(a)(3).

205 See proposed Rule 3110.19(a)(4). Rule 3110(f)(2)(A)(ii) and (iii) identify the conditions for the primary and non-primary residence exclusions. For a discussion of those exclusions, see Section II(A)(1)(c) above.

206 See proposed Rule 3110.19(a)(5).

207 See proposed Rule 3110.19(a)(6).

member firm's supervision in accordance with Rule 3110;[208] and (8) the associated person's electronic communications (e.g., email) are made through the member's electronic system.[209]

One commenter opposed the requirement, set forth in proposed Rule 3110.19(a)(1), that only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location.[210] This commenter stated that this proposed condition would not provide any meaningful investor protection safeguards because associated persons who reside together "to afford the rising cost of housing" do not necessarily pose a higher risk to investor protection.[211] This commenter further stated that this proposed condition is "unnecessarily narrow and restrictive."[212]

In response, FINRA declined to modify proposed Rule 3110.19(a)(1).[213] FINRA emphasized that the proposed rule change "is intended to align with one of several conditions to the current" primary and non-primary residence exclusions.[214] FINRA also noted that the proposed rule change aligns with SEC Books and Records rules, which provide (among other things) that "a broker dealer is not required to maintain records at an office that is a private residence 'where only one associated person (or multiple associated persons who reside at that location and are members of the same immediate family) regularly conducts business.'"[215] Although FINRA declined to modify this proposed condition, it stated that it would consider

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[208] See proposed Rule 3110.19(a)(7).

[209] See proposed Rule 3110.19(a)(8).

[210] CAI at 1-2.

[211] See CAI at 1-2, Exhibit A at 2.

[212] See CAI, Exhibit A at 2 ("The Committee believes that this language is unnecessarily narrow and restrictive and would limit the ability of a location, in several common scenarios, to claim [RSL] status, without providing any meaningful investor protection safeguards.").

[213] FINRA Response I at 3-4.

[214] Id. at 3.

[215] Id. at 3-4 (quoting 17 CFR 240.17a-4(l)).

relevant comments "in connection with future initiatives to consider the OSJ and branch office definitions more broadly."[216]

A second commenter requested that FINRA modify proposed Rule 3110.19(a)(7), which would require that the associated person's correspondence and communications with the public be subject to the member firm's supervision in accordance with Rule 3110.[217] The commenter stated that this language improperly focuses on the recipient (as opposed to the subject) of the communications, and its reference to "the public" is unclear.[218] The commenter recommended that the condition instead require that "all correspondence and communications by the associated person related in any way to existing or potential business activities [be] subject to the firm's supervision in accordance with [Rule 3110]."[219]

In response, FINRA declined to modify proposed Rule 3110.19(a)(7).[220] FINRA explained that the proposed language "aligns with existing rule text used in the primary residence exclusion in Rule 3110(f)(2)(A)(ii)[(e)] and aligns with the terminology in FINRA Rule 2210 (Communications with the Public)."[221] Adopting the commenter's proposed alternative would, FINRA stated, "create an incongruity within Rule 3110 and raise questions about the difference in meanings."[222]

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216 Id. at 4. FINRA acknowledged that Rule 3110(f)(2) does not define "immediate family," but it noted that this term is defined in Rule 3241. Id. at 4 n.12.

217 See proposed Rule 3110.19(a)(7); NASAA I at 1 ("We reiterate and incorporate our previous comments on [File Number FINRA-SR-2022-019]"); see also NASAA (8/23/2022) at 12 (addressing the same provision), https://www.sec.gov/comments/sr-finra-2022-019/srfinra2022019-20137298-307861.pdf.

218 See NASAA I at 1; see also NASAA (8/23/2022) at 12.

219 Id.

220 Letter from Kosha Dalal, Vice President and Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated Oct. 31, 2022, at 8, available as Exhibit 2b to File Number FINRA-SR-2023-006 (addressing the same provision).

221 Id.

222 Id.

A commenter requested to expand proposed Rule 3110.19(a)(7) to require that "all correspondence and communications by the associated person related in any way to existing or potential business activities [be] subject to the firm's supervision in accordance with [Rule 3110]."[223] However, Rule 3110 already imposes broad supervision requirements to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules, and those obligations would apply to RSLs.[224] Moreover, the proposed condition's use of the term "communications with the public" aligns with language in FINRA Rule 2210, the SEC Books and Records Rule,[225] and the preexisting residential exclusions,[226] and so should be familiar to both firms and to regulators. For these reasons, it is reasonable for FINRA to retain the same condition as that for the primary and non-primary residence exclusions.

No other commenter offered specific support for or opposition to any of the remaining six conditions adapted from the primary and non-primary residence exclusions.[227]

Each of these eight conditions imposes a reasonable limitation on the designation of an RSL. Limiting an RSL designation to a location with only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, is a reasonable limitation in light of FINRA's stated intention to align the condition with the SEC Books and Records rules.[228] Restrictions on activities that occur at the RSL, such as prohibitions involving interactions with customers (e.g., not holding the office out to the public, not meeting

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223 See NASAA I at 1; NASAA (8/23/2022) at 12.

224 FINRA Rules 3110(a); see FINRA Rules 3110(b)(4), 3110.06, and 3110.09.

225 17 CFR 240.17a-4(b)(4) (requiring preservation of "[o]riginals of all communications . . . which are subject to the rules of a self-regulatory organization of which the member, broker[,] or dealer is a member regarding communications with the public.").

226 FINRA Rule 3110(f)(2)(A)(ii)(e).

227 Proposed Rule 3110(a)(2) through (6), (8).

228 See supra note 215 and accompanying text.

customers or prospective customers in-person, and limitations on sales activities) and the handling of customer funds and securities,[229] will limit higher risk activities occurring at an RSL that may benefit from more frequent inspection of the location. Furthermore, requiring an associated person to be assigned to a designated branch office and to name that branch office on all of their communications with the public[230] provides investors with information about the person with whom they are conducting business. In addition, the affirmative obligations in the conditions, such as explicitly subjecting the associated person's correspondence and communication with the public to the member firm's supervision and requiring the associated person's electronic communications to be made through the member firm's electronic system,[231] will help provide the member firm with enhanced supervisory oversight of certain activities directly involving investors, and thereby lower risk associated with an RSL. Moreover, incorporating the conditions from the preexisting residential exclusions, a rule that FINRA has experience in administering and that the industry is familiar with, will promote regulatory consistency and minimize regulatory confusion, thereby enhancing investor protection.

b. Books and Records

As its ninth condition for designation as an RSL, the proposed rule change would impose the following recordkeeping requirements: (1) the member must have a recordkeeping system that makes, keeps current, and preserves records required to be made, kept current, and preserved under applicable securities laws and regulations, FINRA rules, and the member's own written supervisory procedures under Rule 3110; (2) such records must not be physically or electronically maintained and preserved at the office or location; and (3) the member must have

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229 Proposed Rule 3110.19(a)(2) through (5).

230 Proposed Rule 3110.19(a)(6).

231 Proposed Rule 3110.19(a)(7) and (8).

prompt access to such records.[232] Because books and records required to be made and preserved would not be maintained on-site at the RSL, FINRA believes that this condition "strengthen[s] a firm's ability to monitor the supervisory activities occurring" at an RSL and lowers overall risk.[233]

Two commenters supported this recordkeeping condition.[234] One stated that requiring members to have "prompt access" to their records "would better enable firms to supervise their associated persons centrally" and "protect against misappropriation and misuse of sensitive customer information."[235] The second commenter agreed with prohibiting the preservation and maintenance of books and records at the RSL.[236] No commenter opposed this proposed condition.

The proposed rule change's recordkeeping conditions are reasonable. Prompt access to an RSL's records from an alternative location decreases the need for more frequent inspection of the RSL. Specifically, the proposed rule change couples the prompt-access requirement with a prohibition on the physical or electronic storage of records at the RSL location. Because records would not be located at the RSL, the member firm should have the ability to supervise the RSL remotely so long as it can promptly access such records, thus decreasing the need for a more frequent inspection cycle. Consequently, the recordkeeping condition would help facilitate the timely and effective supervision of an RSL's business activities.

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232 See proposed Rule 3110.19(a)(9).

233 See Notice at 20576.

234 See NASAA I at 2-3; Davenport at 2.

235 NASAA I at 2-3.

236 Davenport at 2.

c. Surveillance and Technology Tools

The tenth condition for designation as an RSL would require a member firm to "determine that its surveillance and technology tools are appropriate to supervise the types of risk[] presented by each [RSL]."[237] The proposed rule change explains that these tools may include but are not limited to: (1) firm-wide tools, such as an electronic recordkeeping system, electronic surveillance of email and correspondence, electronic trade blotters, regular activity-based sampling reviews, and tools for visual inspections; (2) tools specific to the RSL based on the activities of the associated person assigned to the location, products offered, and restrictions on the activity of the RSL; and (3) system tools, such as secure network connections and effective cybersecurity protocols.[238] No commenter offered specific support for or opposition to this proposed condition.

FINRA justified the proposed rule change, in part, on technological advancements that equip firms to supervise employees working from remote locations.[239] Therefore, it is reasonable to require any member firm taking advantage of the proposed rule change – and its less-frequent inspection cycle – to first determine that its surveillance and technology tools are appropriate to supervise the types of risks presented by each RSL. To aid member firms in this assessment, the non-exhaustive list of tools outlined in the proposed rule change, including firm-

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[237] Proposed Rule 3110.19(a)(10).

[238] See proposed Rule 3110.19(a)(10).

[239] Notice at 20575 ("FINRA believes that the structural and lifestyle changes for member firms and their workforce catalyzed by the pandemic – along with advances in technology – merit reevaluation of some aspects of the branch office registration and inspection requirements."), 20575 (firms indicated that they responded to the COVID-19 pandemic by relying "extensively on technology to support their effective transition to the remote work environment and enhance the supervision of geographically dispersed associated persons, many of whom have been working from home since early 2020 and may continue to do so in some manner in the current environment. These technological tools facilitating their supervisory practices include surveillance systems, electronic tracking programs or applications, and electronic communications, including video conferencing tools.").

wide tools and tools particular to the RSL based on the activities of the person assigned to that RSL, help illustrate FINRA's expectations and will assist firms in implementing robust surveillance systems.

4. Obligation to Provide List of RSLs to FINRA

As stated above, proposed Rule 3110.19(d) would require any member firm that has designated any RSL locations to provide a current list of all of its RSL locations to FINRA on a quarterly basis.[240]

Two commenters supported the proposed rule change, and one of them labeled this quarterly-reporting requirement as "critical" to the ability of regulators "to effectively oversee firms' important supervisory functions."[241] Two other commenters opposed the proposed rule change because of the inefficiency that would result.[242] Instead of a quarterly filing that provides intermittent snapshots of RSL designations, the opposing commenters recommended that FINRA leverage CRD and the existing branch office registration process to continuously collect timely information on RSL designations.[243] For example, one opposing commenter emphasized that using the existing branch-office registration process would provide FINRA "with more current

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240 Proposed Rule 3110.19(d) ("A member that elects to designate any office or location of the member as an RSL pursuant to [proposed Rule 3110.19] shall provide FINRA with a current list of all locations designated as RSLs by the 15th day of the month following each calendar quarter in the manner and format (e.g., through an electronic process or such other process) as FINRA may prescribe.").

241 NASAA I at 2; see Davenport at 2.

242 See letter from James Rabenstine, Vice President, NISC and NSLLC Chief Compliance Officer, Nationwide Office of the Chief Legal Officer, Nationwide Financial Services, Inc. and Holly Butson, Chief Compliance Officer, Nationwide Fund Distributors, LLC, Nationwide Financial Services, Inc. to Sherry Haywood, Assistant Secretary, Commission, dated Apr. 24, 2023, at 2 ("Nationwide"); FSI at 3-4.

243 See Nationwide at 2; FSI at 3-4.

information . . . because of existing requirements to amend and update information within 30 days."[244]

In response, FINRA declined to modify the proposed rule change.[245] FINRA indicated, however, that it appreciates the commenters' recommendations and "is exploring ways for firms to provide this information to FINRA and other state regulators in a more efficient manner."[246] No commenter offered a specific response to FINRA's decision not to modify the proposed rule change, although one commenter encouraged FINRA to seek input from its members to avoid creating an "overly burdensome reporting process."[247]

Prompt access to information about a member firm's RSL designations should improve the ability of FINRA to readily identify which of a member firm's locations have been designated as an RSL and more efficiently assess the reasonableness of a member firm's RSL designations and corresponding supervision. Therefore, the proposed rule change's quarterly-reporting requirement is reasonable and would provide FINRA with the information it needs to carry out its regulatory obligations.[248]

5. Risk Assessment

As stated above, proposed Rule 3110.19(e) would require a member firm – prior to designating any location as an RSL – to "develop a reasonable risk-based approach to

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[244] FSI at 3-4; see Nationwide at 2 (recommended "a separate filing for [an RSL] like a Form BR 2, similar to the U4 page 2 process, so that members have a way to track and link Registered Representatives who are supervised from the [RSL] not an OSJ").

[245] See FINRA Response I at 9.

[246] Id.; FINRA Response II at 7 (FINRA "is exploring ways for firms to provide this information to FINRA and state regulators in a more efficient and timely manner, including through the use of existing uniform registration forms or FINRA Gateway.").

[247] XML at 2.

[248] FINRA indicated that it is exploring ways to structure this data-collection requirement, and it expressed appreciation for the commenters' suggestions. FINRA Response I at 9; FINRA Response II at 7.

designating such office or location as an RSL, and [to] conduct and document a risk assessment" that considers five mandatory factors.[249] These factors would require consideration of, among other things, customer complaints, firm-imposed heightened supervisory plans, and regulatory communications indicating a failure to reasonably supervise.[250] The proposed rule change also would require the member to account for any higher risk activities occurring at the location, any higher risk associated persons assigned to the location, and any indicators of irregularities or misconduct (i.e., red flags) prior to designating a location as an RSL.[251] Further, the proposed rule change would provide that member firms should review red flags – and consider evidencing their review – in determining whether it is reasonable to maintain an RSL designation for a particular location.[252] FINRA explained that this risk assessment – and the non-exhaustive list of factors to consider – would strengthen supervisory controls and further investor protection "by requiring firms to consider higher risk criteria in determining whether to designate an office or location as an RSL."[253]

One commenter offered unqualified support for the proposed rule change.[254] Two other supportive commenters asked that FINRA clarify and modify one aspect of proposed Rule

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[249] Proposed Rule 3110.19(e); Amendment No. 1 at 8; Amendment No. 2 at 4-5. The five mandatory factors are: "(1) customer complaints, taking into account the volume and nature of the complaints; (2) heightened supervision other than where such office or location is ineligible for RSL designation under [proposed Rule 3110.19(c)(3)]; (3) any failure to comply with the member's written supervisory procedures; (4) any recordkeeping violation; and (5) any regulatory communications from a Regulator, indicating that the associated person at such office or location failed reasonably to supervise another person subject to their supervision, including but not limited to, subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, 'blue sheet' requests or other trading questionnaires, or examinations." See proposed Rule 3110.19(e).

[250] See supra note 103 and accompanying text.

[251] Proposed Rule 3110.19(e).

[252] Id.

[253] FINRA Response I at 9-10; Amendment No. 1 at 8.

[254] Cetera II at 1 ("We endorse the requirement for member firms to develop and document a risk-based assessment before designating a location[] as an RSL. This approach is both logical and proportional.");

3110.19(e)(5).[255] As originally proposed in Amendment No. 1, the risk assessment would have required members to consider, among other things, "any regulatory communications from a Regulator, including but not limited to, subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, 'blue sheet' requests or other trading questionnaires, or examinations *indicating that the associated person at such office or location failed reasonably to supervise another person subject to their supervision*."[256] The commenters that asked for modifications both questioned whether the italicized language modified the preceding illustrative list or only "examinations."[257]

In response to the commenters' concern about ambiguity in the scope of proposed Rule 3110.19(e)(5), FINRA reorganized the proposed rule text to improve its readability.[258] As modified by Amendment No. 2, proposed Rule 3110.19(e)(5) reads as follows: "any regulatory communications from a Regulator, indicating that the associated person at such office or location failed to reasonably supervise another person subject to their supervision, including but not limited to, subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, 'blue sheet' requests or other trading questionnaires, or examinations."[259]

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see XML at 2 ("In addition to the time needed to address other requirements in Rule 3110.19, members will need adequate time to develop policies and procedures to comply with the location assessments and documentation requirements of Rule 3110.19(e) and time to implement and perform such activities.").

[255] SIFMA II at 1-2 (offering general support for the proposed rule change); Fidelity II at 2 ("We conceptually support the addition of a risk assessment and appreciate there may be instances where use of the RSL is not appropriate.").

[256] Proposed Rule 3110.19(e)(5) (emphasis added); Amendment No. 1 at 8.

[257] SIFMA II at 2-3 ("It is not clear whether the emphasized phrase is meant to modify all the listed types of communications or only examinations. It may be difficult to determine how these non-investigatory communications indicate a risk presented by an RSL absent an indication of supervisory concern."); Fidelity II at 2 ("It is not clear whether the phrase '*indicating that the associated person at such office or location failed reasonably to supervise another person subject to their supervision'* is meant to modify all the listed types of communications or only examinations.")

[258] FINRA Response II at 8; Amendment No. 2 at 4.

[259] Proposed Rule 3110.19(e)(5); Amendment No. 2.

One opposing commenter stated that the risk assessment's requirement "to 'consider' higher risk criteria" is insufficient.[260] For example, this commenter stated that red flags and many of the risk assessment's factors should constitute eligibility exclusions, not just factors for a member to consider.[261] In addition, the commenter criticized FINRA's "complete lack of guidance as to how to weigh and assess the various risk criteria," including the volume and nature of customer complaints.[262]

In response, FINRA stated that it "expects that a firm will consider customer complaints and weigh their volume and nature based on the firm's business, products, and customer base among other factors generally considered by the firm when making risk-based assessments in other contexts, such as in how a firm may establish and maintain a supervisory system that is appropriately tailored to the firm's business and structure, whether unannounced visits to an office or location may be appropriate, or whether heightened supervisory procedures may need to be imposed."[263]

As stated above, the proposed rule change's member- and location-level exclusions prohibit the designation of RSLs in certain circumstances that may indicate a higher potential risk of non-compliance. But other factors not explicitly identified among the exclusions can, in certain circumstances, indicate heightened levels of risk either before or after RSL designation. Proposed Rule 3110.19(e) will help to mitigate residual risk not explicitly addressed in the conditions, firm-level exclusions, and location-level exclusions. Specifically, the proposed rule

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[260] PIABA II at 4.

[261] Id.

[262] Id.

[263] FINRA Response II at 7; see FINRA Response I at 7 ("FINRA emphasizes that the enumerated list of factors is non-exhaustive. While consumer-initiated, investment-related arbitration or civil litigation is not listed as one of the enumerated factors under proposed Rule 3110.19(e), FINRA agrees that the presence of such arbitration or civil litigation would be a factor for a firm to consider as part of the risk assessment.").

change would require a member firm to assess and document for each associated person at a candidate RSL certain indicia of risk, including the volume and nature of customer complaints, any firm-imposed heightened supervisory plans, and any regulatory communications indicating that the associated person failed reasonably to supervise another person subject to their supervision, prior to RSL designation. In addition, the proposed rule change would require a member to account for any higher risk activities occurring at the location, any higher risk associated persons assigned to the location, and any red flags when designating a location as an RSL. Furthermore, the proposed rule change emphasizes consideration of red flags as part of a member firm's ongoing determination of whether it is reasonable to maintain an RSL designation. In this way, the proposed rule change helps to ensure that a member firm designating RSLs appropriately accounts for the full range of risks associated with each proposed RSL. For these reasons, the proposed rule change is reasonable.

A commenter asserted that the five factors in the risk assessment should instead be eligibility exclusions and noted the absence of guidance as to how to weigh and assess the various risk factors.[264] As an assessment of the risk associated with each factor will depend on the facts and circumstances of each case, no single factor lends itself to an automatic exclusion. For example, customer complaints may, in certain cases, indicate an unacceptable level of risk, but in other cases, complaints may be overly broad or lack factual development to indicate the level of risk. Moreover, as discussed below, this is an ongoing risk assessment, and its outcome could change with new circumstances or as the member firm obtains additional information. Therefore, it is reasonable for FINRA to instead require that firms consider each factor as part of a person-specific risk assessment prior to RSL designation. Similarly, it is reasonable that the

[264] PIABA II at 4.

proposed rule change provides member firms flexibility as to how to weigh and assess the various risk factors.

6. Frequency of Inspections

RSL designation would permit firms to inspect the location on a regular periodic schedule (presumed to be at least every three years) instead of the annual schedule otherwise required for OSJs and supervisory branch offices.[265] Two commenters opposed this less-frequent inspection cycle and contended that RSLs should be inspected annually.[266] Emphasizing the importance of effective supervision, one commenter stated that "[l]ax or otherwise ineffective supervision can result in the failure to stop preventable harms before they occur, or even exacerbate harms that have already begun."[267] Although the commenter did not dispute the emergence of the hybrid work environment and supervision technologies, it contended that those developments have no "bearing on the appropriate frequency or depth of

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265 Proposed Rule 3110.19(a); FINRA Rules 3110(c)(1)(C) and 3110.13. Virtu Financial, Inc., and Nationwide submitted out-of-scope comments regarding the frequency and method of inspections. Virtu asked FINRA to modify the proposed rule change "to codify that all personal residences where only electronic activities are carried out, whether those be supervisory or other securities-related activities, are non-branch locations and reconsider the need to conduct any physical inspections of an associated person's residence and instead rely on technological monitoring tools and electronic recordkeeping." Letter from Thomas M. Merritt, Deputy General Counsel, Virtu Financial, Inc., to Vanessa Countryman, Secretary, Commission, dated Aug. 1, 2023, at 2 ("Virtu"). Nationwide asked FINRA to permit certain limited-purpose OSJs, supervisory branch offices, and RSLs to be inspected remotely and/or on a five-year inspection cycle. Nationwide at 1-2. Because the proposed rule change is designed to establish a new location designation (RSL) for certain personal residences at which supervisory activities occur, the recommendations regarding the method of inspection are outside the scope of the proposed rule change. Because Nationwide appears to request an amended inspection schedule for any limited-purpose OSJ, supervisory branch office, or RSL – regardless of its status as a personal residence – the request to for a five-year inspection cycle is likewise outside the scope of the proposed rule change. FINRA stated, however, that it would consider these recommendation "more generally as part of any future initiatives to consider the OSJ and branch office definitions more broadly." FINRA Response I at 13; FINRA Response II at 9.

266 NASAA I at 3; NASAA II at 5; PIABA I at 3 ("[R]esidential supervisory locations should at minimum be subject to annual in person audits, if not more frequent unannounced visits, rather than periodic inspections every three years.").

267 NASAA I at 3.

scrutiny of supervisory activities."[268] It also contended that "FINRA has not shown that supervisory functions present sufficiently 'lower risk' to warrant loosening oversight of individuals performing those functions."[269]

In response, FINRA declined to require annual inspections for RSLs, explaining that "impos[ing] an annual inspection cycle on an RSL would adversely impact the utility" of the proposed rule change.[270] FINRA stressed that "the inspection requirement is only one part" of a member firm's "ongoing obligation" to supervise under Rule 3110, and "a firm's inspection of an office or location is not the only occasion during which a firm supervises its associated persons."[271] Indeed, FINRA stated that Rule 3110 "does not preclude a firm from conducting inspections of its offices or locations more frequently or conducting unannounced visits."[272] FINRA also stated that the proposed rule change includes "a rigorous set of safeguards and conditions that . . . align with the regulatory purposes of Rule 3110."[273]

The proposed rule change permits – but does not require – member firms to inspect their RSLs on a less frequent inspection cycle. This proposed rule change is reasonable for two reasons. First, the proposed rule change is reasonable in light of Rule 3110's general obligation to establish and maintain a reasonably designed supervisory system that is tailored to its unique business operations and associated risks. Although an RSL designation would permit a member firm to inspect a location on a less frequent schedule, the proposed rule change would not limit inspections to this less frequent schedule. Instead, Rule 3110 contemplates that a member firm

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268 Id. at 4.

269 Id. at 3; see NASAA II at 5.

270 FINRA Response I at 10-12.

271 Id. at 12.

272 Id.

273 Id. at 11.

may, in certain circumstances, choose to conduct more frequent or unannounced visits to an RSL in furtherance of its obligation to supervise effectively. In this way, the proposed rule change is consistent with that obligation.

Relatedly, the Rule 3110 requirement to maintain a reasonably designed supervisory system is an ongoing obligation. A firm may need to reconsider a residence's RSL designation, and the corresponding relief from annual inspection, if circumstances suggest that the designation may no longer be appropriate. Importantly, proposed Rule 3110.19(e) indicates that firms should review red flags when determining whether it is reasonable to maintain an RSL designation. The various terms and conditions associated with initial RSL designation therefore are only the beginning of an ongoing assessment of a location's qualification for RSL designation and less frequent inspections.

Second, the proposed rule change is reasonable in light of its terms and conditions. The member- and location-level eligibility exclusions would identify – and exclude – certain firms and locations with characteristics that may indicate a higher potential risk of non-compliance.[274] Additionally, an eligible member firm may designate its eligible location as an RSL only if it complies with ten conditions, such as limitations on customer interactions, a recordkeeping requirement, and a mandatory technology assessment.[275] Even if an eligible member firm is prepared to comply with those ten conditions, it must still "develop a reasonable risk-based approach to designating [the eligible location] as an RSL, and conduct and document a risk assessment for the associated person assigned to" the proposed RSL.[276] These layers of protection are designed to limit RSL designation (and its less-frequent inspection cycle) to

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274 Proposed Rule 3110.19(b), (c).

275 Proposed Rule 3110.19(a).

276 Proposed Rule 3110.19(e).

locations without indicia of increased potential risk of non-compliance. With those safeguards, a regular periodic inspection schedule is reasonable for those locations that can comply with the proposed rule change's various terms and conditions.

IV. Solicitation of Comments on Amendment No. 2

Interested persons are invited to submit written data, views, and arguments concerning whether Amendment No. 2 is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an email to rule-comments@sec.gov. Please include File Number SR-FINRA-2023-006 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-2023-006. This file number should be included on the subject line if email 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. Do not include personal identifiable information in submissions; you should submit only information that you wish to make available publicly. We may redact in part or withhold entirely from publication submitted material that is obscene or subject to copyright protection. All submissions should refer to File Number SR-FINRA-2023-006 and should be submitted on or before [INSERT DATE 21 DAYS FROM PUBLICATION IN THE FEDERAL REGISTER].

V. Accelerated Approval of Proposed Rule Change, as Modified by Amendment Nos. 1 and 2

The Commission finds good cause to approve the proposed rule change, as modified by Amendment Nos. 1 and 2, prior to the thirtieth day after the date of publication of notice of the filing of Amendment No. 2 in the Federal Register.[277] In Amendment No. 2, FINRA modified the proposed rule change – in direct response to comments received – to clarify the substantive intent of proposed Rule 3110.19(e)(5). FINRA did not propose to change any substantive obligation of the proposed rule change. To reduce ambiguity regarding its scope, FINRA instead proposed to reorganize a single sentence describing a single factor in the mandatory risk assessment.[278] The basis for this amendment is the same as the basis for the original proposed rule change, as modified by Amendment No. 1, which the Commission previously noticed for public comment.

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[277] See 15 U.S.C. 78s(b)(2)(C)(iii).

[278] See supra notes 258 through 259 and accompanying text.

After consideration of the comments FINRA received on the proposed rule change, the Commission concludes that Amendment No. 2 represents a reasonable extension of, and is substantially similar to, the language originally proposed for proposed Rule 3110.19(e). The Commission also concludes that Amendment No. 2 responds to comments received, adds clarity to the proposed rule change, and does not raise any novel regulatory concerns. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,[279] to approve the proposed rule change, as modified by Amendment Nos. 1 and 2, on an accelerated basis.

VI. Conclusion

For the reasons set forth above, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with Section 15A(b)(6) of the Exchange Act, which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and, in general, protect investors and the public interest.[280]

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279 15 U.S.C. 78s(b)(2).

280 15 U.S.C. 78o-3(b)(6).

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Exchange Act[281] that the proposed rule change (SR-FINRA-2023-006), as amended by Amendment Nos. 1 and 2, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[282]

Sherry R. Haywood,

Assistant Secretary.

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[281] 15 U.S.C. 78s(b)(2).

[282] 17 CFR 200.30-3(a)(12).