

COMMENT LETTER

January 11, 2018

ICI Files Comment Letter Supporting FINRA's Proposal Relating to Remote Inspections of Qualifying Offices (pdf)

January 11, 2018 Jennifer Piorko Mitchell Office of the Corporate Secretary FINRA 1735 K Street, NW Washington, DC 20006-1506 Re: Remote Branch Office Inspections; FINRA Notice 17-38 Dear Ms. Mitchell: The Investment Company Institute¹ is writing in response to FINRA's request for comment on Supplementary Material .15 that FINRA proposes to add to Rule 3110.2 FINRA Rule 3110, which governs a member's supervisory responsibilities, requires an onsite inspection of all member locations. Supplementary Material .15 would revise this requirement by providing FINRA members the option of conducting remote inspections of locations that meet specified criteria. For mutual fund underwriters, adoption of the proposal will relieve them from having to conduct onsite inspections of the locations of their regional distributors and wholesalers who operate out of their personal residences. Because the onsite inspections of these locations render no benefit to investors and serve no public purpose, we strongly support FINRA's proposal. 1 The Investment Company Institute is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, unit investment trusts, and 529 plans in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of \$21.2 trillion in the United States, serving more than 100 million US shareholders. 2 See Remote Branch Office Inspections, FINRA Notice 17-38 (Nov. 13, 2017). Jennifer Piorko Mitchell January 11, 2018 Page 2 FINRA currently requires onsite inspections of all member locations. Its proposal is intended to reduce the burden of these inspections in limited circumstances that would not result in a diminution in investor protection. It will do so by permitting a FINRA member to remotely inspect any office or location that meets the definition of "qualifying office"³ so long as the member satisfies the rule's requirements. These requirements include that the member establishes and maintains policies and procedures reasonably designed to (1) ensure the location satisfies the definition of qualifying office and (2) assess whether a remote inspection is reasonable for the location.⁴ The Institute has long recommended that FINRA accommodate the unique business of regional distributors and wholesalers of mutual fund underwriters when it imposes regulatory requirements on its members.⁵ This is because the business of a mutual fund underwriter is significantly different from that of a full-service broker-dealer. Indeed, unlike retail broker-dealers, mutual fund underwriters do not sell mutual funds to shareholders. Instead, they retain regional distributors and wholesalers to educate retail broker-dealers about their funds so the broker-dealers can sell those funds to the public.

These regional distributors and wholesalers typically operate out of their personal residences and the business-related activities they conduct are limited.⁶ Their residences are not held out to the public as a place where securities business takes place, retail investors do not visit these locations, and there are no required books and records maintained at them. For these reasons, we have previously recommended that FINRA not require onsite inspections of these locations. Prior to its current proposal, however, FINRA believed it was necessary in the public interest for all member locations to have an onsite inspection. ³ Supplementary Material .15(b) would define the term “qualifying office” as a location that: (1) does not have more than three associated persons who conduct business for the member “designated to the location”; (2) is not held out to the public; (3) exclusively uses the member’s authorized electronic systems and platforms to conduct business; (4) complies with any applicable recordkeeping requirements; (5) does not handle customer funds or securities; and (6) is not the location of a person with a disciplinary history. Also, the location must either: (1) not be required to be inspected annually; (2) be designated as an office of supervisory jurisdiction (OSJ) solely because of specified supervisory activities; or (3) be designated as a branch office solely because of supervisory activities. With respect to condition (1), we would appreciate FINRA clarifying, when it adopts the Supplementary Material, that this condition means that no more than three associated persons list the location on their Form U-4 as their “Office of Employment Address.” ⁴ Pursuant to FINRA’s proposal, a member shall determine the reasonableness of remotely inspecting a location by considering the factors listed in FINRA Rule 3110.12. These factors are: 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 the location; and any indicators of irregularities or misconduct (i.e., “red flags”). ⁵ See, e.g., Letter from the undersigned to Mr. Chip Jones, Vice President, Registration and Disclosure, NASD (June 21, 2006). This letter sought clarification of the treatment of personal residences of mutual fund distributors and wholesalers under the supervision rules of the NASD, FINRA’s predecessor. ⁶ The activities they conduct at their personal residences generally consists of: phone calls and emails conducted through the members’ electronic systems and platforms; handling travel and expense reports; and preparing or revising reports related to their distribution activities. Jennifer Piorko Mitchell January 11, 2018 Page 3 We are very pleased that the definition of offices that may be remotely inspected under Supplementary Material .15 (i.e., “qualifying offices”) will encompass the personal residences of mutual fund regional distributors and wholesalers. This means that, once the proposed revisions are adopted, mutual fund underwriters will be able to remotely inspect these locations. We concur with FINRA that the business activities that take place at the homes of regional distributors and wholesalers present a low risk of harm to investors. As such, adoption of the proposal will not result in a diminution of investor protection. It should instead enhance investor protection by enabling FINRA members to deploy the resources they currently expend to inspect these low-risk locations on areas of their business that may present higher risks to investors.⁷ In our view, FINRA’s proposal strikes an appropriate balance between ensuring that FINRA’s members have the flexibility necessary to appropriately oversee their operations and preserving the investor protection purposes behind FINRA’s inspection requirement. We commend FINRA for its proposal and we strongly urge its adoption. Regards, /s/ Tamara K. Salmon Associate General Counsel ⁷ The Institute would also support FINRA exempting members from having to conduct any inspections of the homes of regional distributors and wholesalers. We believe that the same factors cited in support of permitting the remote inspections of these locations would also support exempting them from FINRA’s inspection requirement.

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