

RECORDING OF VOICE AND ELECTRONIC COMMUNICATIONS

The FSA has published its Policy Statement (PS) confirming its proposals to make the recording of electronic communications mandatory for firms taking client orders and concluding transactions in the equity, bond, and derivatives markets.

The move is intended to standardise existing practices amongst firms, which varies widely, and assist the FSA in enforcing and investigating suspected cases of market abuse.

The new rules will come into force on 6th March 2009.

1. KEY POINTS

1.1 Changes to Original Proposals

The FSA originally set out its plans in Consultation Paper (CP) 07/9 and several changes have been made to the original proposals as follows:

- There will be a reduction in the time that firms will be required to hold the recorded conversations – now only six months (original proposal was three years).
- Mobile telephone conversations are to be excluded for the time being (although this is to be reviewed in 18 months time).
- Discretionary investment managers will not now be required to record telephone conversations and electronic communications with firms that are subject to the taping rules (although such firms might still wish to do this as “best practice”).

1.2 Firms Affected

This is laid down in COBS 11.8.1R and includes any firm receiving client orders and negotiating, agreeing, and arranging transactions across the equity, bond, financial commodity and derivatives markets. This means all firms that:

- receive, execute or arrange for client orders to be executed;
- carry out transactions on behalf of the firm, or another person in the firm's group, and which are part of the firm's trading activities or the trading activities of another person in the firm's group;
- execute orders that result from decisions by the firm to deal on behalf of its client; or
- place orders with other entities for execution that result from decisions by the firm to deal on behalf of its client;

This potentially includes intermediary firms (IFAs) where they undertake any of the above activities for securities or for collective investment schemes that are not insurance company style schemes (see below).

The requirement for firms to record their telephone conversations is based on the financial instruments in which they transact business rather than what type of firm they consider themselves. Any firm that concludes transactions in any instrument subject to the Market Abuse regime (fundamentally investments traded on regulated markets) will be required to record such orders. This includes the equity, bond and derivative markets.

This has implications for some IFAs. A retail intermediary IFA firm acting as such will not receive, execute or arrange for client orders to be executed on shares or on collective investments that are not insurance company backed and these firms will not be caught by the recording requirements. However, some IFA firms do not restrict themselves to retail investments and do carry out such transactions and may therefore be subject to the recording requirements. The crucial factor is that the products subject to the Market Abuse regime are those whose price is determined by market factors and potentially subject to manipulation, as opposed to life company products which are underwritten.

Any firm in doubt as to whether they are affected by the new rules should contact us without delay.

1.3 Firms NOT Affected

The following are not affected by these requirements:

- Corporate finance business and corporate treasury functions;
- Discretionary investment managers (see below);

and

- Research analysts;
- Retail financial advisers; and
- Back-office staff

when acting in these capacities.

Discretionary investment managers are not required to record their conversations and electronic communications with other firms that are subject to the taping rules, as they are entitled to rely on the “sell side” firms taping the calls. However, our advice is that this should still be considered on a non-mandatory basis as best practice.

Discretionary investment managers will also not be required to record conversations and communications with firms who are not subject to the taping rules (such as overseas brokers not subject to FSA regulation) only if such conversations and communications are infrequent, and a small proportion of the total relevant conversations and communications made by the discretionary investment manager. Again, however, this should be considered as best practice.

“UCITS qualifiers” are excluded – this relates to operators, trustees and depositaries of collective investment schemes as a firm type. Again, our advice is that this should still be considered on a non-mandatory basis as best practice.

1.4 Communications to be recorded

Firms will be required to take “reasonable steps” to record any communications involving facsimile, email and instant messaging devices. It includes fax, email, Bloomberg mail, video conferencing, SMS, business to business devices, chat and instant messaging; in short any electronic communications involving receiving client orders and the agreeing and arranging of transactions. No prescribed list (which could become out of date quickly) has been laid down. This is an example of the principles based approach, where the FSA has determined its desired outcomes, and leaves it to individual firms and management to exercise their judgement in this area.

Conversations on mobile telephones are excluded for the time being – subject to a review in 18 months time – as the technology to record calls is still very new and untried, and many firms ban their use on trading floors. The FSA is therefore acknowledging the practical difficulties of including such conversations, but recording may be brought in at a later date when technology catches up with regulatory objectives.

The conversations to be recorded include any that are used to conclude or intended to conclude a transaction. Conversations on general market conditions and general conversations are not included. The financial instruments covered are based entirely on the scope of the Market Abuse regime, which covers a range of “qualifying investments” or related instruments admitted to trading on a “prescribed market”. These are defined by the Treasury in the Prescribed Markets and Qualifying Investments Order.

The term “reasonable steps” is intended to reflect the fallibility of equipment, and that there may be occasions when relevant conversations or communications take place on equipment that is not recorded because it is not normally used for such conversations or communications. No precise definitions or guidance of what constitutes “reasonable steps” has been given, and firms will be expected to determine for themselves what is “reasonable”. However, the FSA has said that it will work with trade bodies to develop easily understood interpretations and more material may therefore be forthcoming. (See point 2 below.)

1.5 Retention Periods, Retrieval and Record Keeping

The FSA has amended the proposals in CP07/9, where it had originally proposed requiring firms to keep recordings for a three year period. The required period has now been reduced to six months.

Records must be kept in a form that is easily accessible to the FSA (the FSA says that the norm for supplying records to it on request is seven working days), and that if changes to the original records have been made then these should be easily identifiable.

Although firms will only be required to keep all records for six months, the FSA may notify a firm that it wants certain records to be put aside. In this case, a firm might need to keep some records for a longer period.

1.6 Outsourcing

The FSA has made it clear that the outsourcing of taping to third-party service providers will not be considered a critical or important function for the purposes of SYSC Chapter 8, and so the conditions relating to outsourcing in SYSC 8.1.8R will not apply to such outsourcing.

2. ACTIONS THAT SHOULD BE TAKEN BY AFFECTED FIRMS

Affected firms should obviously ensure that they have the recording systems in place and operational by the time that the new rules come into effect in March 2009. They should also ensure that they have adequate storage systems and retrieval or filing facilities in place to ensure records are kept for the prescribed minimum period, can be accessed when and if required, and that such systems can record if changes have been made, and ensure the original records are kept.

Firms should also be aware of their obligations under the Data Protection Act 1998, which require firms to notify clients of how data is processed (in this case the fact that calls are recorded) and impose appropriate storage and access obligations.

3. WHAT IS GOING TO HAPPEN NEXT

The FSA will now undertake follow up work with the various Trade Associations to develop industry guidance to help members on the practical application of the rules.

The new rules will come into force on 6th March 2009.

4. FURTHER INFORMATION

The PS and Instrument making the Rules can be found (together with a supporting a study by the consultants Europe Economics, which examined the accuracy of the figures quoted in the cost/benefit analysis in CP07/9 and the feasibility and cost of recording mobile phone conversations) at the following link on the FSA website:

http://www.fsa.gov.uk/pages/Library/Policy/Policy/2008/08_01.shtml

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