

Red Tape: The FSA's new telephone taping rules

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As part of its strategy on the deterrence and detection of market abuse, the FSA has published revised rules that will, from March 2009 onwards, require firms to record and retain telephone conversations and other electronic communications.¹ Interestingly, as a result of the FSA's consultation with the market, these rules are a significantly watered down version of the draft rules proposed by the FSA back in May 2007.²

It is anticipated that many larger firms will already have comprehensive systems in place for recording, retaining, and recovering telephone conversations and electronic communications. However, this article will serve as: (1) a checklist to ensure that current systems will be compliant in March 2009; and (2) a guide to smaller firms that may be recording conversations and communications for the first time. We also provide commentary on the merits of the rules.

DRIVERS FOR CHANGE

The FSA's view is that the recording of telephone conversations and electronic communications³ will: (1) increase the probability of successful enforcement; (2) reduce expected value to be gained from market abuse; and (3) lead to increased market confidence. The FSA cites a key advantage of telephone evidence as its ability to indicate knowledge and intent; critical to enforcement, but not always apparent from documentary evidence or oral testimony.

THE LIMITED SCOPE OF THE RULES

Activities

The essentials of the "taping requirement" originally proposed still stand: firms must take reasonable steps to

record relevant telephone conversations and retain relevant electronic communications.⁴ Broadly, "relevant" conversations and communications⁵ are those which are made between a firm and its client or, when acting on behalf of its client, another person, for the firm to receive, execute, arrange, or place orders, or carry out transactions on behalf of itself or its group, whether as principal or agent.⁶

Instruments

The financial instruments covered under the original proposal are "qualifying investments" (e.g. equities, bonds, and derivatives) admitted or requested to be admitted to a "prescribed market", or related instruments. This has not changed under the revised rules.

Exceptions

However, the revised rules cut back the application of the taping requirement. The rules clearly provide that conversations and communications of research analysts, retail financial advisers, and back office personnel are not expected to be recorded.⁷ Activities carried on between operators of collective investment schemes, corporate finance business, and corporate treasury functions are already excluded.⁸ Crucially, under the revised rules, discretionary investment managers are also exempt from the taping requirement where either: (1) their conversations and communications are with firms subject to the taping requirement; or (2) their conversations and communications are infrequent and constitute a small proportion of the total relevant conversations and communications.⁹

The revised rules also clarify that the taping requirement only applies to conversations that are intended to lead to the conclusion of an agreement (even if not ultimately concluded), and not to general conversations about market conditions.¹⁰

¹ Policy Statement 08/1 – Telephone Recording: recording of voice conversations and electronic communications – March 2008

² Consultation Paper 07/9 – Conduct of Business regime: non-MiFID deferred matters (including proposals for Telephone Recording) – May 2007

³ Including email, fax, and instant messaging

⁴ COBS 11.8.5R

⁵ COBS 11.8.8R

⁶ COBS 11.8.1R and 11.8.8R

⁷ COBS 11.8.9G(2)

⁸ COBS 11.8.2R

⁹ COBS 11.8.6R

Finally, and importantly, conversations and electronic communications (except emails) using mobile phones are specifically exempted from the recording rules, although this position will be reviewed in 18 months. This is because many market participants informed the FSA that this was simply not technically feasible.

Outsourcing

Many firms' first instinct will be to seek a third party to provide recording services to meet the taping requirement. The FSA has facilitated this by amending the Senior Management Arrangements, Systems and Controls rules so that the outsourcing of taping will not be a "critical or important" function,¹¹ and will not therefore be subject to the full effect of SYSC 8.

Retention and Retrieval

As under the original proposal, a firm must record all relevant conversations and communications so that they are readily accessible to the FSA, and alterations can be identified.¹² However, critically, while under the original proposal the retention period was three years, under the revised rules, this has been reduced to six months. Again, this was as a result of pressure brought to bear by market participants.

COMMENT

The FSA's decision to refine its original "sledgehammer" proposal for telephone conversation and other electronic communications is a good example of how market participants, acting collectively and vigorously, can influence the rules and guidance coming out of Canary Wharf.

Costs estimates for the implementation of the new rules vary wildly. We believe that the impact on larger firms will be relatively minimal; many are already compliant with the rules. However,

we are concerned that small to medium sized entities, such as retail stockbrokers and boutique brokerages and managers, who have not thus far recorded conversations and electronic communications, will need to develop whole new systems and may therefore feel the bite of the new rules much more painfully.

From the opposite perspective, there is concern that the rules do not go far enough to achieving the FSA's stated objectives. If the rules are really intended to deter and detect market abuse, then it is doubtful whether six months is a long enough retention period. Many abusive practices may not come to light until well after six months, by which time records may have been deleted. Equally, the exemption of mobile telephone communications from the taping requirement may lead unscrupulous traders to conduct orders via mobile phone.

Either way, we are looking forward to working closely with our clients to ensure that they comply with the latest red tape issued by the FSA.

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¹⁰ COBS 11.8.9G(1)

¹¹ SYSC 8.1.5R(3)

¹² COBS 11.8.10R