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Hangin' on the telephone

Financial institutions buying and selling shares for clients are now required to hold telephone and email recordings for at least six months, says the FSA

The new Financial Services Authority (FSA) rules regarding the recording of telephone and email communications are now in force, a year to the day after the FSA published its Policy Statement on 6 March, 2008. UK financial institutions that buy and sell shares, derivatives and bonds for clients now need to record telephone calls and email exchanges and keep them for at least six months. This change has been designed to deter and detect market abuse and insider

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dealing by making it more difficult to commit market abuse offences and easier to gather the evidence to prove these offences.

Previously, the Conduct of Business Sourcebook Rules (COBS) required firms to make a record immediately of every order received from clients and any decisions made in providing portfolio management including details of the transaction and financial instrument and the name of the client.

The COBS (Recording of Telephone Conversations and Electronic Communications) Instrument 2008 provides a new provision (COBS 11.8) specifically dealing with the recording of telephone conversations and electronic communications. Now a firm must take reasonable steps to record relevant telephone conversations and keep a record of relevant electronic communications for at least six months (or longer, if the FSA specifically demands it). However, conversations or communications which are not intended to lead to the conclusion of an agreement but are general conversations about market conditions are exempt from the rules. In addition, discretionary investment managers will not be required to record telephone conversations and electronic communications with firms that are subject to the taping rules. The FSA has also controversially exempted mobile telephone conversations from the taping rules. It does, however, propose to review this in six months' time.

There has already been a need for some clarification of the rules. For example, the British Venture Capital Association has requested clarification on the scope of the rules and the exemptions with regard to private equity firms. The FSA stated that it "expects the majority of the transactions undertaken by private equity or venture capital firms, whose core business is growing the value of privately-held companies, to be outside the scope of the rules". Of course, some of their activities will involve communications in relation to transactions in investments and will, therefore, be caught by the new rules.

There are some open issues with the new rules. For example, small- to medium-sized firms may find the rules burdensome. The rules require them to pick and choose what to record but this could result in these firms having to record everything. These rules could also lead to firms breaching privacy laws in other countries or having to comply with complex data gathering and storage laws; for example, employees could demand transcripts of calls that they have conducted. These new rules also have a potentially wide and ambiguous application as 'electronic communications' include facsimile, email and instant messaging devices.

The FSA has not produced an exhaustive list in order to catch future developments in technology but, as mentioned above, mobile telephones are exempt from the rules, potentially allowing orders to be made free from recording. After extensive consultation, the initial period proposed to retain records was reduced from three years to six months. It has been questioned whether the revised period is long enough, as abuses may well come to light long after the records have been deleted.

The FSA has estimated the initial set-up costs for the industry to be between £9m and £14m, with annual expenses for storage and retrieval to be in the region of £6m-£11m, but that the long-term economic benefits, which the FSA predicts will flow from the rules, outweigh the costs to the industry. It has stated that the rules will enable more successful enforcement actions, which in turn will diminish the value gained from market abuse. This, it is hoped, will lead to increased market confidence and therefore greater price efficiency. Nevertheless, in the short term the implementation of these rules will inevitably have a substantial financial effect on businesses. It is yet to be seen whether the rules will have a detrimental effect on the competitiveness of UK financial institutions. There is a risk that many firms simply cannot afford to implement the rules or they may in future decide they prefer less regulation and leave the UK market.

Before the year ends, these rules are due to be reviewed twice. First, the exemption for mobile telephones will be reviewed in September 2009. Second, in December 2009, the European Commission is due to report on whether the discretion afforded to member states under Article 51 of the Markets in Financial Instruments Directive in respect of taping requirements is appropriate. The FSA will then undertake a further review of the taping rules in light of the Commission's report.

Whether the new rules are just an isolated measure or the beginning of increased FSA oversight and greater regulatory control is yet to be seen. With the forthcoming reviews, there are many extensions to the rules the FSA could implement. It has been suggested that it could insist on written transcripts of conversations, an increased retention period, reasons for advice being given, day-by-day updates on the existence of insider dealing or market abuse and, of course, the inclusion of mobile telephones. With the FSA currently facing growing criticism with regard to its 'light touch' approach to regulation, there is a distinct possibility that its rules will become more wide reaching and onerous.

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