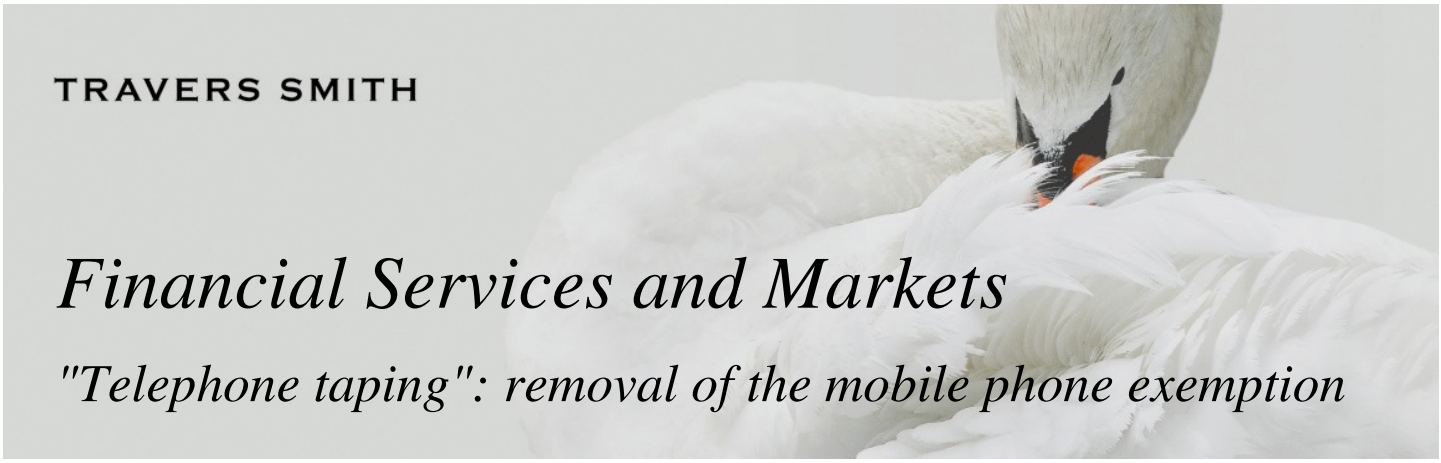

TRAVERS SMITH

Financial Services and Markets

"Telephone taping": removal of the mobile phone exemption

Despite strong objections from the industry, the FSA has confirmed that the so-called mobile phone exemption is to be removed. Affected firms now have a year to make the necessary – and potentially expensive – technological changes so that they are ready to tape mobile phone calls when the new rules come into force on 14 November 2011.

On 11 November 2010 the FSA published PS10:17: Taping of mobile phones – Feedback on CP10/7 and final rules. In the policy statement, the FSA has essentially rejected all of the various concerns raised by respondents to the March 2010 consultation paper and has settled on its proposed rule changes as consulted upon.

The current position

Firms may currently rely on an exemption from the obligation set out in COBS 11.8.5R to take all reasonable steps to record all relevant telephone conversations and keep copies of all relevant electronic communications made with, sent from or received on equipment provided by the firm (or which the firm has allowed to be used). This exemption (in COBS 11.8.6R(1)) extends to telephone conversations and electronic communications made with, sent from or received on mobile telephones or other mobile handheld electronic communication devices (although this exemption does not extend to e-mails sent or received through such devices).

What is changing?

As from 14 November 2011 this exemption will disappear and the obligation to record in COBS 11.8.5R will extend to all relevant telephone conversations and relevant electronic communications made through equipment provided (or sanctioned for use) by the firm, including those made through mobile phones and electronic communication devices.

In addition, from the same date there will be a new rule requiring firms to take reasonable steps to prevent an employee or contractor from making, sending or receiving relevant telephone conversations and electronic communications on privately-owned equipment which the firm is unable to record or copy.

We attach our Q&As on the FSA's recording requirements which we originally published in 2008 when the details of the current recording regime were settled. The Q&As have been updated, where appropriate, to reflect the removal of the mobile phone exemption next year but they also serve as a reminder to firms of the scope of the existing requirements.

What should affected firms be doing?

All affected firms must now start considering what improvements they need to make to their systems in order to ensure that they remain compliant as from 14 November next year. In outline, and depending upon the extent to which they permit the use of mobile communications devices, they will need to consider some or all of the following steps:

- revisiting their existing policies and procedures regarding the use of mobile technology;
- considering whether and to what extent they will allow firm-issued equipment to be used for trading purposes;
- budgeting for the expense of buying a technology solution from one of a number of suppliers in the market – that solution will need to be tailored to the needs of the firm (e.g. depending upon the type of handsets issued, whether a third party server is required etc) and will need to be purchased and tested well before, and be up and running by, 14 November 2011;
- updating their compliance policies and procedures (including the provision of appropriate training) to ensure that employees and contractors understand that they must not use privately-owned equipment for trading purposes.

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Recording telephone conversations and electronic communications – Q&As

When do the requirements apply from?

The current rules, which broadly apply to communications made through landlines and non-mobile electronic equipment and to e-mails sent through mobile devices (such as BlackBerries), came into force on 6 March 2009. As from 14 November 2011, the rules will be changed so that (a) the recording obligation will extend to relevant calls and communications made through mobile phones and other handheld devices provided by firms (or sanctioned by them for use) and (b) firms will be required to take reasonable steps to prevent the use of privately-owned equipment for such conversations and communications.

What is the requirement to record?

A firm must take reasonable steps to record relevant telephone conversations and keep a copy of relevant electronic communications made with, sent from or received on equipment provided by the firm to an employee or contracts (or equipment which the firm has sanctioned) to enable the employee or contractor to carry on certain trading activities (COBS 11.8.5R).

You should note that the obligation is not expressed as an absolute one – a firm must take "reasonable steps" to record relevant conversations and communications. There is no guidance in the rules as to what "reasonable steps" might be: the FSA is of the view that this is a principles-based requirement and each firm must decide for itself what steps are reasonable for it to take in order to comply with the recording requirement. See below for what should be recorded and what "reasonable steps" might include.

What activities are caught by the requirements?

The rules apply to communications in relation to certain trading activities carried out in relation to certain traded investments (or instruments related to such traded investments).

The relevant activities are:

- receiving or executing client orders or arranging for such orders to be executed;
- carrying out transactions on behalf of the firm, or another entity in the same group where those transactions are part of the firm's (or associate's) trading activities; and
- executing orders, or placing orders with other entities for execution, where those orders result from decisions by the firm to deal on behalf of its clients (i.e. subject to the qualified exemption below, investment managers *are* caught).

In each case, all telephone conversations and electronic communications which conclude an agreement (or in the case of communications with, or on behalf of, professional clients or eligible counterparties, carried on with a view to the conclusion of an agreement) must be recorded.

The relevant investments are:

- 'qualifying investments' admitted to trading on prescribed markets – generally this captures a wide range of instruments (including transferable securities, units in collective investment undertakings, money market instruments and certain types of derivatives) which are admitted to trading (or in respect of which a request for admission has been made) on any of a significant number of markets, including the LSE and AIM in the UK and all regulated markets in the rest of Europe; and
- investments which are 'related investments' in relation to such qualifying investments – this captures investments whose price or value depends on the price or value of a qualifying investment (e.g. an OTC derivative).

What activities are exempt from the requirements?

The following activities are not subject to the recording requirements (even if carried on by firms that might otherwise be subject to the requirements when carrying on other activities – see above):

- corporate finance business;
- corporate treasury functions; and
- activities carried on between operators (or between operators and depositories) of the same collective investment scheme.

In addition, activities carried on by the following persons will not be subject to the requirements on the basis of *guidance* from the FSA that it would not "ordinarily" expect conversations of such persons to be caught:

- research analysts;
- retail financial advisers; and
- persons carrying on back office functions.

What types of firm are exempt from the requirements?

The following are not within the rule requirements, regardless of the activities they carry on:

- service companies;
- non-directive friendly societies;
- non-directive insurers;
- UCITS qualifiers.

In addition, there is a qualified exemption for discretionary investment managers when acting in that capacity (see below).

What is the application of the recording requirement to discretionary investment managers?

The starting position is that discretionary investment managers (e.g. segregated portfolio managers, hedge fund managers and private equity managers) are caught: executing orders resulting from decisions on the part of a firm to deal on behalf of its client and placing such orders for execution with third parties are relevant activities within the scope of the recording obligation. There is, however, a qualified exemption for discretionary investment managers, when they are acting in that capacity. They do not have to record where:

- they reasonably believe that the other party to the conversation or communication (e.g. a broker) is an FSA regulated firm subject to the COBS 11.8 recording obligation; or
- in relation to conversations with persons not subject to the recording obligation (e.g. overseas brokers), (1) such conversations or communications are infrequent and (2) only form a small proportion of the total conversations and communications made or received by the manager (the large majority of which are subject to the recording obligation). If your firm relies on this, it should ensure that it is in a position to be able to demonstrate to the FSA the requisite lack of frequency in relation to, and the proportional size of, the relevant conversations or communications.

It should be noted that this exemption will remain in place after 14 November 2011. One might argue that, in theory at least, the removal of the mobile phone exemption ought not to have an impact upon those firms who are reasonably relying upon the discretionary investment managers' exemption. However, in practice the removal of the mobile phone exemption may well present issues for those managers who permit the use of mobile technology by staff for the purposes of their trading activities. These issues are likely to be particularly acute where firms have conversations with persons who are not subject to the COBS 11.8 recording obligation (such as overseas brokers) but seek to rely on the exemptions outlined in the second bullet above. As noted above, when relying on this limb of the exemption firms must be able to *demonstrate* to the FSA the fact that such conversations are infrequent and proportionally insignificant; in practice this may be harder to do where mobile technology owned by an employee is used.

What should be recorded by firms that are within scope?

All telephone conversations and electronic communications with a client (or with another person when acting for a client) which *conclude* an agreement by the firm to carry on any of the activities caught by the requirements (see above). Furthermore, communications with, or on behalf of, a professional client or eligible counterparty, must also be recorded where they are carried on *with a view to the conclusion of such an agreement*, even if in fact an agreement is not ultimately reached.

The term "electronic communication" is not defined in the FSA rules and therefore has a wide application. It includes faxes, e-mails (including e-mails sent by BlackBerries or similar devices), Bloomberg mails, video conferencing, SMS, business to business devices, chat and instant messaging.

The recording obligation applies to conversations and communications made with, sent from or received on equipment which is either provided by the firm to its employees or contractors or the use of which has been sanctioned or permitted by the firm.

The current position is that telephone conversations and electronic communications (other than e-mails) made with, sent from or received on a mobile phone or other mobile handheld communication devices do not need to be recorded. This exemption will disappear on 14 November 2011 so that where such mobile phones and communication devices are *provided by the firm* (or otherwise sanctioned for use) all relevant conversations and communications on them will also have to be recorded.

What steps will we need to take to prepare for the removal of the mobile phone exemption on 14 November 2011?

You could, of course, decide to implement a new (or continue an existing) policy of prohibiting the use of mobile technology for any of the activities covered by the recording obligation.

Assuming you intend to authorise staff to use company-issued mobile devices for the purposes of relevant activities, you will need to upgrade your existing recording facilities so that communications made through such devices can be recorded – this will involve you having to purchase a tailored solution from a technology provider. In 2009 the FSA commissioned Europe Economics to research and report on the cost of introducing a mobile recording requirement. The final report, published in October 2009, was attached to CP10/7 and found that:

- there are two fundamental solutions to *recording* mobile conversations: on the handset itself or on a remote server;
- there are also two fundamental solutions to *storing* recorded conversations: on a hosted server managed by an external third party away from the firm's premises or on a server managed by the firm (either on its own premises or at a third-party data centre).

The smaller your firm, the more likely it is that you will want to use a hosted solution with a server managed by a third party – this will clearly be the cheaper option. The larger your firm, the more complex and costly the implementation process is likely to be. Remember that, whatever your size, you will need a buy a solution which will work according to the type(s) of handsets you provide to employees. In addition, you may want to be able to integrate your new facility to record mobile/handheld messages with your existing facility for recording landline calls (and apparently not all vendor solutions will be able to do this).

What "reasonable steps" should we be taking to comply with the recording obligation and, from 14 November 2011, to prevent the use of privately-owned equipment?

The recording rule (COBS 11.8.5) requires firms to take "reasonable steps" to record relevant telephone conversations and to keep a copy of relevant electronic communications made with, sent from or received on equipment provided by the firm to an employee or contract (or equipment which the firm has sanctioned) to enable the employee or contractor to carry on relevant trading activities.

From 14 November 2011, the disappearance of the mobile phone exemption will be complemented by the insertion of a new rule (COBS 11.8.5A) requiring a firm to take "reasonable steps" to prevent its employees and contractors from using privately-owned equipment which the firm is unable to record or copy for the purposes of relevant conversations and communications. This will apply to private equipment such as mobile phones, BlackBerries, PDAs etc.

The FSA has refused to elaborate by way of guidance in the rules as to what might constitute "reasonable steps" for these purposes. What it has done – in a rather non-committal way – is to provide some comment by way of feedback to a request in a consultation response[1] for some clear guidance on this point. Extrapolating from those comments by the FSA, "reasonable steps" to comply with the rules may, assuming that they are backed up with adequately robust policies and procedures, include the following:

- banning the use of *any* mobile devices (whether firm-issued or privately-owned) for any trading-related purposes – i.e. ensuring that all activities covered by COBS 11.8 are carried out only through the firm's "land lines" and accordingly recorded – on this basis, the firm might be able to comply with the recording requirement (both before and after 14 November 2011) without having to go to the expense of buying a solution for recording mobile communications;
- banning the use of all *private* mobile devices in circumstances where they could be used to make or receive relevant conversations or communications (e.g. banning them from use on the trading floor);
- restricting the use of mobile devices provided by the firm by (for instance):
    - limiting the number of individuals permitted to use such mobile devices for the purposes of relevant activities and recording all their conversations/communications, while prohibiting any other individuals from using such devices for such purposes;
    - limiting the type of mobile devices that could be used for the purposes of relevant activities and recording them;
    - in the case of multi-function devices (such as BlackBerries or PDAs) limiting their use to a function which can be recorded (e.g. voice calls);
- ensuring that the firm's compliance manual and compliance procedures are adequately detailed and that all relevant employees are given adequate compliance training as to what they are permitted to do, what prohibitions apply and what sanctions apply for any breaches;

[1] A joint response issued by AFME, APCIMS, BBA and FOA dated June 2010

- auditing paper or order trails in order to determine whether any relevant conversations or communications have occurred which have resulted in the conclusion of an agreement but which have not been recorded in accordance with the rules.

Does this mean that employees will no longer be able to use private equipment for business purposes?

No, not as such, although in our view the continued use of private phones and equipment for business purposes will make it harder for firms to maintain adequate systems and controls in order to comply with the requirements. It is clear that if an employee uses a private mobile phone for business communications that do not involve taking client orders or dealing in financial instruments, then this would not be caught by the recording obligation (the same is true of a phone that is issued by the firm and used for such "non-trading" communications).

However, remember that firms will be required to take reasonable steps to ensure that privately-owned devices that they cannot record are not used for relevant conversations or communications. If your firm does intend to permit the use of private phones and communication devices for business purposes after 14 November 2011, you will need to consider how you will be able to evidence that they are not being used in circumvention of the recording rule. In this regard you might think that a simple solution would be to record privately-owned equipment as well as firm-issued devices. However, the recording of privately-owned phones and communications devices (which will capture personal conversations as well as business ones) would in all likelihood give rise to potentially significant privacy law concerns. This is unlikely to be a workable solution for firms and is certainly not one to be pursued without taking appropriate advice at an early stage.

What is our position if we use the services of a third party to record telephone conversations and electronic communications?

Many firms, particular smaller ones, are likely to need to rely on a third party's remote server for recording purposes. However, where your firm does use a third party it will retain the responsibility for the recording undertaken by that third party. SYSC 8.1.5R(3) provides that the recording and retention of relevant telephone conversations or electronic communications subject to COBS 11.8 will not be considered critical or important functions for the purposes of SYSC 8. That said, you should remember that SYSC 8.1.3G states that a firm should take the SYSC 8 rules into account "in a manner that is proportionate given the nature, scale and complexity of the outsourcing" even where the outsourcing does not relate to a critical or important function.

How long do we need to keep records of telephone and electronic communications?

Six months, under the FSA rules. You may of course choose to keep them for a longer period for other reasons (e.g. as evidence for litigation). In addition the FSA may ask you to keep them for longer if investigation or enforcement proceedings are underway (see Market Watch Issue No.28 (June 2008) in which the FSA explained how it may ask for records to be kept for more than six months). Furthermore, you should note that, as part of its advice to the European Commission on the MiFID Review, CESR has proposed a requirement for records to be kept for 5 years (see below under "Will there be any further changes?").

What is the territorial scope?

The rules only apply to a firm's activities carried on from an establishment in the UK (COBS 11.8.4R).

However, since the firm will be deemed to be carrying on the relevant trading activities (such as executing client orders) from its UK establishment even if an employee carries on the activity using a mobile device in another jurisdiction (or at home), care needs to be exercised on this point.

The FSA's policy position regarding the use of firm-issued mobiles out of the UK office is that firms must assess for themselves whether the COBS 11.8 recording rules apply but that:

- as regards relevant calls made/received on a firm-issued mobile on a regular basis while an employee is in an EU country, it does not believe that national or EU privacy legislation would prevent the firm from recording the calls and these should therefore be recorded;

- as regards relevant calls made/received on a firm-issued mobile on a regular basis while the employee is working from home, these should be recorded;

- it would not expect a firm to record calls made or received on a mobile when an employee is in a non-EU jurisdiction, unless he frequently carries out business this way. In addition, since local privacy laws in such non-EU jurisdictions may make it illegal to record mobile devices (including devices issued by employers) the FSA argues that the "reasonable steps" standard in COBS 11.8.5R would not compel a firm to act in breach of those laws.

These comments of the FSA are made in PS10/17, but are not incorporated into the rules themselves. If the nature of your firm's business is such that employees may frequently use their mobile devices for the purposes of relevant conversations and communications while outside the UK, you may need to consider taking appropriate advice as to whether the recording of these conversations or communications may give rise to privacy law issues.

Do the rules require us to have installed recording facilities at our disaster recovery site?

The rules do not address this point directly. When responding to the initial consultation on introducing telephone taping (PS 08/1), the FSA said that it acknowledged that the cost of doing this could be significant "and it may well be reasonable for a firm to decide not to install" such facilities. While this acknowledgement has not been repeated in CP10/7 or PS10/17, the fact that many firms will be facing potentially significant costs in preparing for the removal of the mobile phone exemption suggests that the FSA is unlikely to pursue firms for not having recording facilities at their disaster recovery sites, at least not without having first publicised the fact that it intends to take a hardened stance (e.g. by way of a Dear CEO letter or other public statement).

Will there be any further changes?

We would not expect the FSA to make any further changes in the immediate future and in any event probably not before 14 November 2011. However, it should be noted that the recording of telephone conversations and electronic communications is one of the many issues being considered by the European Commission as part of its MiFID Review. On 29 July 2010, the Committee of European Securities Regulators (CESR) published its technical advice to the Commission on investor protection and intermediaries and this included specific advice on recording of telephone conversations and electronic communications. While many of CESR's recommendations broadly accord with the UK's regime (particularly as it will apply as from 14 November 2011 when the mobile phone exemption is removed), CESR proposes a stricter requirement as regards record retention (5 years). Depending upon the final position that the Commission decides to adopt, the FSA may have to make additional amendments to its rules in order to conform to the minimum pan-European requirement. Since the new European requirements are unlikely to be in force for some time we therefore do not envisage any further material changes from the FSA before November of next year.

Remind me – what's the point behind all of this?

When one gets into the detail of the FSA's recording requirements it is perhaps easy to forget the rationale behind the regime. It is primarily there to help to deter and detect market abuse. Records of telephone conversations and electronic communications provide evidence of what was said at the time of entering into transactions. The FSA has the power to call for recordings (see Market Watch 28) so the safe *retention* of recordings is as important as the process of ensuring that relevant conversations and communications are recorded. The FSA must be able to gain access to the recordings readily. If any corrections or amendments are made to the records it must be possible to ascertain the contents as they stood before any such corrections or amendments – i.e. so that persons cannot manipulate the records in an attempt to hide potentially abusive behaviour.