19 Telephone Recording – recording of voice conversations and electronic communications

Introduction

19.1 The prevention, detection and deterrence of market abuse is a key priority for the FSA. Good quality recordings of voice conversations and of electronic communications assist firms and the FSA in the detection of inappropriate behaviour, and in its investigation and punishment. Importantly, the knowledge that such behaviour can be detected and may be punished acts as a deterrent to individuals who might be tempted to act inappropriately. We have therefore reviewed our current provisions for firms to make and retain such communications and propose to make rules to require firms to record certain telephone lines and to retain certain electronic communications.

Existing provisions

19.2 Section 3.6 of our Market Conduct Sourcebook (MAR) includes guidance on the circumstances in which firms might find it appropriate to maintain records of voice conversations. These are not rules, however, and we propose to replace this material with the rules on which we are now consulting.

Drivers for change

19.3 The proposed requirements support a key priority of FSA to further the prevention, detection and deterrence of market abuse. It is appropriate to consider bringing changes now because of the significant changes that the implementation of MiFID will bring to the organisational and conduct of business requirements for firms with effect from 1 November 2007. Our proposed rules and guidance, however, will apply more widely.

Proposal

19.4 We propose firms be required to record telephone lines used for voice conversations that involve the receipt of client orders and the negotiating, agreeing and arranging of transactions across the equity, bond and financial commodity and derivatives markets, and to retain electronic communications relevant to these activities. The term electronic communications has wide application and includes fax, e-mail, chat and instant messaging – but, obviously, is not limited to those.

19.5 Activities within the scope of our proposals include proprietary trading and other principal dealing and agency broking and the associated sales functions. The range of instruments is drawn deliberately widely but does not capture insurance-based or collective investment scheme (CIS) products, but, to the extent that they are regulated activities does capture the dealing activities of individuals managing such funds. So, relevant firms will include banks, stockbrokers, investment managers generally (including CIS managers and hedge fund managers) and insurance companies. Outside the scope of the proposals are: the activities of individuals who are investment managers but who do not have authority to deal; retail financial advisers; corporate finance advisers – unless, of course, they also carry on the relevant activities – and treasury and back office functions.

19.6 The purpose of our proposals is to deter individuals within regulated firms from acting on the basis of inside information and from manipulating the market, and to assist the investigation of cases where there has been misconduct.

19.7 We propose that firms be required to retain the records for three years from the date of creation.

19.8 We also propose that the records be kept in such a way that they are accessible for future reference; that any corrections or other amendments, and the contents of the records prior to such corrections or amendments, must be easily ascertained; and, that it must not be possible for the records otherwise to be manipulated or altered. This is in accordance with the MiFID general record-keeping standard.

Implications for firms

19.9 A wide variety of firms will be captured by these proposals; in principle, firms who employ individuals or contractors that carry out orders in a wide range of financial markets or, within those markets, who are engaged in institutional sales. Our assessment is that firms currently tape at least 90% of the lines that will be caught by the new requirement. For many firms, the main implication will be the need to ensure that all relevant conversations take place on lines that are recorded and that records are stored to appropriate standards for later inspection, for example, to support a later internal or FSA investigation.

19.10 For the minority of cases where individuals are not currently captured by voice recording and other systems, there may also be additional hardware costs. In practice we consider that smaller firms are more likely than larger to need to install new equipment. The technology is readily available and its costs have reduced considerably over the past few years. The technology for capturing and recording

electronic communications such as e-mail, instant messaging and chat is also readily available. We do not intend to define a standard here that goes beyond current commercial practice – for example, unless there is reason to suppose employees might set out to falsify their e-mail records, elaborate anti-tampering measures, other things being equal, should not be necessary.

19.11 Our proposals do not of course prevent firms from recording telephone conversations more widely than required under our detailed proposals nor relieve firms from other specific and general record-keeping requirements.

Implications for consumers

19.12 These requirements are designed to assist in reducing the incidence of market abuse in the UK markets and hence increase market confidence and protect consumers.

Cost-benefit analysis: summary

19.13 A fuller cost-benefit analysis is provided towards the end of this chapter. In summary our assessment is that the proposals will capture about 55,000 to 70,000 individuals and that the business lines of about 90% of these are currently taped. We estimate total one-off costs in installing relevant hardware and software will be around £3m to £4m with incremental continuing costs of retention and maintenance in the range £3.5m to £4.5m per year.

19.14 The knowledge that conversations will be recorded and readily available to compliance departments and to the FSA will deter a greater proportion of individuals from potentially inappropriate actions. We also expect that as a result of these requirements a greater number of cases of suspected market abuse will be detected and will be susceptible to investigation by our Enforcement Division with successful outcomes. This supports our market confidence and financial crime objectives.

19.15 The economic benefits of cleaner markets are increased market confidence (leading to a lower cost of equity), and improved stock price accuracy (and consequently efficiency in resource allocation). However, it is difficult to quantify the extent to which better taping and recording practices themselves add to these benefits of cleaner markets.

References

- There are no equivalent existing provisions, although there are some relevant current provisions in MAR 3.6, which shall be superseded.
- The Market Abuse Directive (2003/6/EC) imposes obligations on Member States to prevent, deter and detect market abuse using a variety of measures. Article 13(6) of MiFID imposes a high level record-keeping obligation on firms subject to MiFID and Article 25 obligations to promote the integrity of the market. Article 51 of the MiFID Implementing Directive refers to record-keeping requirements and the right of Member States to impose obligations on investment firms relating to the recording of telephone conversations and electronic communications involving client orders.

- Draft rules implementing these proposals are at COBS 12.8.

Q19a: Do you agree that our proposals for firms to make and retain recordings of voice conversations and of electronic communications in respect of individuals carrying out certain functions will assist the detection, prevention and deterrence of market abuse and assist in protecting consumers?

Q19b: Do you agree with the scope of our proposed requirements?

Q19c: Do you agree that our proposed 3 year retention period is appropriate?

Q19d: Do you have any comments on our detailed rules' proposals?

Cost-benefit analysis

Summary of key changes

19.16 Firms will be required to record telephone lines used for voice conversations that involve the receipt of client orders and the negotiating, agreeing and arranging of transactions across the equity, bond and financial commodity and derivatives markets, and to retain electronic communications relevant to these activities (including e-mail, chat and instant messaging).

19.17 This would capture individuals acting as dealers or brokers in those markets including principal dealers, agency brokers, institutional sales and investment managers with authority to deal, but not other investment managers or research analysts or corporate finance advisers. Firms will be required to retain such records for three years from the date of creation.

Overview of the population of individuals and firms affected

19.18 Individuals within these proposals include principal dealers and agency brokers (in respect of any type of client or counterparty) and the associated sales functions. A wide variety of firms will be affected: they include banks, stockbrokers, investment management firms generally (including CIS and hedge funds) and insurance companies.

19.19 A precise estimate of the population size of individuals that may be affected is not possible because the FSA only has data on firms' permissions and controlled functions. These do not correspond exactly with the activities covered by the proposed policy. A particular complexity is distinguishing the extent to which individuals who primarily engage in investment advisory or investment management roles and are listed as approved persons under these categories, also deal. Based on further information gathered from firms, our estimate of the number of individuals likely to be affected by our proposals is in the range of 55-70,000 individuals.

Data Sources

19.20 In developing our CBA the sources of information we have used include:

- an estimation of costs and a review of recording technologies used in the market prepared by Actica Consulting for the FSA;
- responses to questions in a survey sent out to firms regarding information on current recording norms;
- responses to questions in the 2005 LECG survey of firms regarding MiFID implementation;
- input from our policy, enforcement, market monitoring, supervisory and legal experts; and
- desk-based analysis of firm-level permissions information, individual-level controlled functions information and additional data.

Costs

One-off costs of telephone recording

19.21 Most firms already record telephone conversations for the type of individuals our proposed policy will apply to, for example, to ensure compliance with existing exchange requirements and for dispute resolution. Replying to our survey, firms indicate they tape between 70 and 100% of all such individuals. We assume, based on the median figure of survey responses, that 90% of these are currently taped. As a result incremental one-off costs are expected to be minimal for most firms but more significant for those that need to increase the proportion of individuals taped to meet proposed policy standards. Our surveys show that some smaller firms, particularly smaller investment management firms, do not tape all their dealing lines. This is where compliance costs will arise.

19.22 Several technologies are available in the market for recording telephone conversations. Actual usage of different standards and systems depends to a large extent on firm size. Small participants are likely to subscribe to a number of lines from a telecoms provider such as BT. They are likely to use entry-level single box solutions or alternatively telephones with built-in recording facilities to record conversations. Medium and large participants are more likely to have a Private Automatic Branch eXchange (PABX) installed that allows many local extensions to share a lower number of incoming lines. They are increasingly likely to use a Voice over Internet Protocol (VoIP) technology for their telephony, which allows several possibilities for configuring a recording solution.

19.23 Based on discussions with suppliers, Actica report that one-off costs arising from purchasing and installing recording solutions[34], depending on the type of technology

34 Including storage capacity for the first year

used and size of firm is likely to range from around £200 to £600 per line. From a median figure of £450 and the understanding that telephone conversations of 90% of individuals required to be taped by the proposed policy are already recorded, we estimate one-off costs for all firms to be in the range of about £2.5m to £3m.

One-off costs of electronic communication recording

19.24 A number of alternatives to voice telephony are increasingly being used for communication. These include e-mail, chat, instant messaging, and web-forms. Because firms might already be recording some of these communication methods, or because commercial off-the-shelf solutions (COTS) employed might already provide recording functionality, or because usage of certain of these alternatives may not be in place for smaller participants particularly, we expect incremental one-off costs to be significantly smaller than those estimated for recording telephone conversations.

19.25 E-mail services used by firms range from web-based public versions for smaller firms to internally hosted proprietary products for larger firms. The ability to record and archive email is already available across the entire range of product types used. Small incremental costs may only arise for some smaller firms that need to augment their level of assurance, for example, by adding archiving ability.

19.26 Instant messaging and chat are relatively new communication tools in the financial services industry, and are unlikely to be used within a significant proportion of firms for business communication. Some free variants may not have recording capability, but there are free alternatives available which provide this functionality. Firms may incur some compliance cost in ensuring communications by individuals using these are always recorded and archived. Additionally recent products e.g. Microsoft's Live Communication Server 2005 and Akonix provide recording and archiving as part of their functionality, and a higher level of assurance. Costs of such products range from £3,000 - £4,000, plus around £25 per user.

19.27 Dealing with client orders and other communications through web systems has become more common. These allow clients to monitor their accounts and transactions and interact with their service provider. Web systems, due to their nature, result in very specific operations performed by the user as they are restrained by the forms and fields that are provided. Both major methods used to ensure inputs reach firms already produce records. The typical solution generates emails from data entered into web forms. Alternatively the web interface is integrated with the firm's CRM or other operational system. Some incremental compliance costs may arise from enhancing assurance.

19.28 We estimate that overall one-off costs for all firms from having to meet the electronic communication requirement proposed should not be more than £1m.

Continuing costs of recording telephone and electronic communication

19.29 Continuing costs for firms are expected to have two drivers: maintenance of recording systems and storage costs arising from the three year retention requirement. Actica report from their investigation, maintenance costs on average

will be around £50 per individual every year. For the individuals whose communications are currently not recorded, there would be an incremental maintenance cost totalling around £250,000 - £350,000 per annum.

19.30 Storage costs depend on the amount of data generated that will need to be recorded and retained. The large majority of data created will be from voice recording. Electronic communication storage is estimated to generate less than 10% of incremental on-going storage costs.

19.31 Incremental costs will arise not only for individuals whose communications were not previously recorded, but also for firms who currently record but do not retain communications for three years. As an indicator, our survey of firms reveals about half of firms in the sample report retention periods of over 5 years. However, almost half also report very short retention periods, of less than one year. We estimate a retention requirement of 3 years will lead to incremental continuing storage costs in the range of £3m to £4m per annum.[35]

Total compliance costs

19.32 In summary, the total one-off costs will total around £3m to £4m, with incremental continuing costs in the range £3.5m to £4.5m per annum.[36]

19.33 This assessment of compliance costs is subject to two main caveats. These cost estimates are based on the assumption that it is fixed lines, rather than mobile phones that are being recorded. If mobile phones are used in connection with orders, firms will have to record conversations, or, change their working practices. Technologically it is possible to route all calls made on work mobiles from a firm's office through a single server so that calls can be recorded. But this is not understood to be common practice and we have not estimated how this would affect costs.

19.34 The second caveat is that we have not obtained evidence that firms would need to change their business processes, other than recording and storing information on the lines they are already using, in order to fulfil the requirement that orders are not agreed on lines which are not recorded. We know that in some areas the need to change would be limited, for many firms do not allow the use of mobile phones on trading floors. But for some other firms, we consider it possible that the requirement to agree orders only on recorded lines may lead to some restrictions on the way they transact business and might give rise to additional costs. We welcome evidence on this point.

35 As illustration of how these costs arise we can consider an example of a firm needing for the first time to record the communication of 100 individuals. Initial hardware, installation and first year storage capacity would cost, at about £550 per individual (£350 for telephone lines and installation, £100 for one-off costs relating to electronic communications and £100 for the first year's storage capacity) a total of £55,000 for the firm. If the lines are used on average for 70% of an 8 hour working day and speech is recorded at 16 kbits per second (or 2 kilobytes per second) then each line will in one day generate about 40,000 kb of data (or 40MB) and 100 lines about 4,000MB (4GB) of data. Across a 260-day working year the total data is about 1,000 GB or 1 terabyte (TB). Assuming also that a back-up copy is kept, we cost storage of 1 TB of data for such a firm at £10,000. Maintenance at £50 per individual would add another £5,000 in on-going costs for the firm. We understand that firms may be using alternative technologies, with different costs, for example analogue taping. Our discussions with suppliers indicate installation and retention should not be more costly for alternative recording solutions.

36 Our cost estimates are based on the understanding from surveyed firms that phone lines of 90% of individuals where our proposals will apply are already taped. If the actual number of currently taped individuals were lower, for example 80%, then we would expect one-off cost of around £6-8m and on-going costs of around £4-5m, per annum.

Other negative impacts

19.35 We considered if it were possible that some mobile firms who prefer a lighter regulatory touch may exit the UK market. Given that communication is already recorded, for a large proportion of individuals where the proposals apply, we do not expect major market impact. But we also understand from our surveys that some smaller investment management firms do not record dealing lines. So we consider it is possible there may be such an impact, in particular for some hedge funds.

Benefits

19.36 Individuals working within issuers of financial instruments and in investment firms and the investment firms themselves can have access to inside and other privileged knowledge which they can use to exploit for illegitimate profit. Our proposed taping recording requirements aim to address the market failure which arises where such trading undermines market confidence. Our aim is to increase the probability of successful enforcement, thus reducing the profit incentive to exploit the information asymmetry and acting as a further deterrent to exploitative behaviour.

19.37 We identify the mechanisms through which recording voice and electronic communication may lead to economic benefits as follows:

- recording increases the incidence of enforcement action;
- increased enforcement leads to cleaner markets; and
- cleaner markets lead to better market outcomes.

19.38 Successful enforcement action is dependent on the strength of evidence secured. Where available, taped conversations and good quality electronic records may provide an enforcement investigation with additional valuable information. Analysis of a sample of cases investigated by our Market Monitoring Department suggests taping is associated with a greater probability of cases being pursued. Additionally tape recordings have provided useful or critical evidence in a number of our Enforcement investigations.

19.39 Increased enforcement may lead to cleaner markets. Theoretically, if the likelihood of getting caught and incurring a punishment increases, the expected value and hence the number of individuals committing abuse, will decrease. Recent FSA research corroborates this to some extent[37].

19.40 The economic benefits of cleaner markets are increased market confidence (leading to a lower cost of equity), and improved stock price accuracy (and consequently efficiency in resource allocation). A link between enforcement or cleaner markets,

37 FSA Occasional Paper 25: *Updated Measurement of Market Cleanliness* Examining price sensitive announcements of FTSE350 firms, the analysis indicates that enforcement may have contributed, at least to some extent, to cleaner markets. The measure of market cleanliness for all announcements (other than takeovers) by FTSE350 firms is calculated to have moved from pre-FSMA (19.6%), to post-FSMA (11.1%), to post-Enforcement (2%). By contrast, however, the proportion of take-over announcements preceded by significant price rises did not decrease to the same extent and was 23.7% in 2005 compared to 32.4% in 2004.

and economic benefits from reduced insider trading is described and to some extent measured in published academic research.[38]

19.41 Since the communications of most individuals our proposals cover are already recorded, we need to consider whether there is scope for significant incremental benefits. Past FSA experience demonstrates in several market abuse investigations, which involved the types of individual covered by these proposals, while firms may have kept tapes, these were either not readily available or were not retained after a short time period. It is possible the retention element of the proposed policy may lead to improvements in enforcement and consequently improved market outcomes as described through the mechanism above. However, it is difficult to estimate the extent to which recording of voice and electronic communication itself adds to the benefits of cleaner markets.

19.42 The benefits of taping different kinds of firms/functions differs according to the extent to which firms have access to inside information; already tape; and can side-step use of taped communication because there is time to communicate through other means. We acknowledge that the ability of market abusers to avoid imparting incriminating information on taped lines or other forms of communication covered by this proposal constrains the scale of benefits. However, as noted above, in practice taped evidence has proved useful in FSA enforcement cases.

19.43 Our view is that taping more widely than we are proposing could lead to economic benefits – we do not claim that dealers are more likely to be involved in insider trading than other kinds of market participant. However, as they are largely taped already, the ratio of benefits to costs is likely to be highest for this group.

Other options considered

19.44 We also considered the possibility of imposing similar requirements on other types of individuals working within financial services firms. Roles examined were those of investment managers who do not have dealing authority, research analysts, corporate finance advisors, and retail financial advisors. Our analysis suggested it would be disproportionate on market failure and cost-benefit grounds to impose recording requirements on these functions. This analysis is summarised below.

19.45 The estimated compliance costs of imposing recording requirements on other types of functions are set out in the table below. Significantly lower proportions of these functions are currently taped compared to those for which we are proposing to introduce recording requirements. On a per individual basis, the incremental costs of extending our proposals to these additional functions are therefore considerably higher.

38 (a) Negative correlation (-0.49) between two global indices of insider trading and equity market efficiency (The Global Competitiveness Report Insider Trading Index and The World Bank FDSI Equity Market Efficiency Index), indicating that reducing insider trading may be economically efficient. This analysis is subject to some caveats and so this finding may not be robust
(b) Some cross-country empirical support for the position that prices may be more accurate and hence markets more efficient where insider rules are more stringent (Beny, L N (2006) *Insider Trading Laws and Stock Markets Around the World*, University of Michigan Law School Working Paper.)
(c) There is evidence that increased enforcement action against insider trading reduces cost of equity generating benefits that may represent millions of pounds per annum (Bhattacharya, U and Daouk, H (2002), *The World Price of Insider Trading*).

	Population	Proportion currently recorded	One-off costs	Incremental on-going cost (per annum)
Investment managers (without dealing authority)	12,000	10% to 50%	£3m to £5m	£0.5m to £1m
Investment Research Analysts	5,000	50%	£1.25m	£0.5m
Corporate Finance Advisors	10,000	10%	£4.5m	£1m

Investment managers without dealing authority

19.46 Were a requirement imposed then to the extent that telephone conversations would be captured by requirements on dealers and sales staff, it might amount to "double banking" and therefore lead to unnecessary dual costs. Also, it is possible a large proportion of calls recorded would be irrelevant to market dealings. The incremental benefit of recording communication of this function directly may then only come from information revealed to (non-taped) third-parties and acted upon. It is not apparent that the benefit this may generate will be outweighed by the cost imposed.

Research analysts

19.47 Since the publication of research and recommendations may lead to changes in the market valuation of companies, analysts may hold price sensitive information, but because they work on a piece of research over a period of time, their access and ability to communicate this information should, in most cases, not be time-critical (though in certain cases it may be). This means there will be more scope for wrongdoers to avoid recorded means of communication.

19.48 Regulation prevents analysts' remuneration being directly linked with profits made on companies/investments they publish research on, so the incentive to pass on information is limited. Indirectly, since remuneration will be linked to the profits their firm makes, and because of the effect of feedback from fund managers on career progression, analysts have some incentive to reveal information.

19.49 Dealing ahead is the primary type of market abuse we consider relevant for research analysts. NERA's 2005 investigation of the market reveals that the level of dealing ahead is quite low (6%), indicating significant further improvement may not be possible. If one of the primary concerns here is information leakage from the research area to the trading desk, then simply taping the latter would solve that part of the problem without duplicating the cost.

19.50 Our analysis suggests that incremental benefits are unlikely to outweigh the costs firms would incur in recording the communication of research analysts.

Corporate finance advisers

19.51 The sorts of transactions corporate finance advisers work on include mergers and acquisitions, sales of companies, and financing of joint ventures. It is apparent that working on such transactions involves access to price-sensitive information. FSA research reveals there are informed price movements ahead of about a quarter of takeover announcements, so it is clear there is room for more effective action.

19.52 However a large number of individuals outside corporate finance firms typically also have access to information, for example solicitors, accountants, PR firms, and individuals within corporations bidding for or being taken over. Many of these would not be captured by any FSA recording of communication requirements. So it is not apparent that simply imposing a requirement on corporate finance advisers would significantly diminish such information being exploited.

19.53 Additionally, given the length of time individuals advising on such deals will work on these projects, it is likely that in the majority of cases the ability to communicate information gained which can be exploited will not be time-critical and therefore alternative methods of communication can easily be substituted. Finally, if traders are already taped, the case for also taping corporate finance advisers is reduced.

Retail financial advisers

19.54 Retail financial advisers who are not close to the securities markets do not generally have access to the sort of information we are concerned with. They also commonly operate face to face, so a recording requirement imposed would likely exclude a large proportion of relevant conversations. We did not cost the imposition of a 'taping' requirement for this function, but since a very large number of retail financial advisers operate in the market, and we do not expect a large proportion of these to be currently taped, incremental compliance costs would be large. It is not apparent the introduction of a recording requirement would be proportionate in addressing a relevant market failure in this area.

Q19e: Do you consider the proposed recording requirements will have additional impact on your business that we have not identified in the cost-benefit analysis?

Q19f: Do you have any further comments on our analysis of the costs and benefits of our proposed recording requirements?