



FOR WHOM THE BELL TOLLS.

MiFID II and the Death of Management by Policy.

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The bell is tolling. Every peel brings closer the death of Management by Policy (“MBP”) for mobile call recording because on January 3rd, 2018 MiFID II – the “Markets in Financial Instruments Directive II”¹ - will come into effect. At its heart is the EU wide requirement for the mandatory recording of mobile telephone calls and electronic communications: a substantial - indeed sweeping - change. It will affect most investment firms trading in the EU who deliver various regulated financial activities.

This paper looks at changes in the law and the experiences in the UK. The UK adopted call recording in 2009, so UK firms have trodden the path of responding to call recording requirements. MBP (the prohibition or restriction of calls on unrecorded devices) has been the response of a number of firms. This paper will consider why MBP is no longer a safe, viable choice to meet MiFID II requirements. The scope of the firms and regulated activities caught by the Directive will be considered in another paper. The phrases “Investment Firm” and “Activities” indicate when they are respectively in scope.

¹ 2014/65/EU

THE NEW EU ENVIRONMENT.



Under MiFID I, the requirement to call record was left to each member state. Since 2009, the UK adopted that requirement and lifted the exemption for mobile calls in November 2010. However, MiFID II makes the requirement mandatory throughout the EU. Furthermore, to ensure a level playing field for competition, MiFID II goes significantly further by setting out many harmonising principles.

Call recording is justified as one of the measures that strengthen “investor protection, to improve market surveillance and increase legal certainty in the interest of investment firms and their clients.”² All legislation – both EU and national – must be read in the context of these aims.

Article 16 (6) states that an “investment firm shall arrange for records to be kept of all services, activities and transactions undertaken by it which shall be sufficient to enable the competent authority to fulfil its supervisory tasks and to perform the enforcement actions” under the directive. “Records” include the recording of telephone conversations or electronic communications.³

Article 16 (7) requires that an Investment Firm takes all reasonable steps to record relevant telephone conversations and electronic communications, made with, sent from or received by equipment provided by the Investment Firm to an employee or contractor or the use of which by an employee or contractor has been accepted or permitted by the investment firm.

A relevant conversation is defined as “telephone conversations... relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders.”

² Paragraph 57 of the Preamble to MiFID II

³ Article 16 (7)

THE UK EXPERIENCE OF CALL RECORDING.



Although MiFID II now extends mobile recording across the whole of the EU, the FCA has been regulating mobile call recording in the UK since 2011. So, it is useful to look at how UK Investment Firms have responded.

Mobile call recording policy was set out in the FSA Policy Statement 10/17. It dealt with the taping of calls on mobile phones. This gave rise to the rule that a firm must take reasonable steps to prevent mobile calls on privately-owned equipment. The principle was reflected in COBs 11.8. of the FSA Handbook. Many Investment Firms went down the route of call recording, taking the benefits that such systems provide (accuracy and completeness of records, ease of storage etc.). Despite the benefits, some firms avoided recording and banned or restricted the use of non-recording privately or corporately owned devices for trading calls – the so-called “Management by Policy”.

MiFID II adopts the same approach; i.e. the requirement to take “reasonable steps”. On the face of it, “Management by Policy” could continue. However, the Investment Firm that now adopts or continues with MBP must be aware that it is submitting itself to a significant number of risks given the changing nature of the regulatory environment.

WHY MBP FAILS.

Firstly, the regulator – in this case, the FCA – has never endorsed the approach. Nowhere has the FCA (or its predecessor, the FSA) gone on record of approving MBP. It has been consistent in its attitude; “reasonable steps” is fundamentally a “principles based” approach and so it, as the regulator, could not be prescriptive. The closest it has come is in acknowledging that a total prohibition or procedures restricting the use of privately owned devices “appear sensible”, but stressed it is only in principle.⁴

The onus is on the Investment Firm to prove it took reasonable steps. The objection of many Investment Firms in the UK to the requirements to call record of mobile calls was cost. Furthermore, some firms objected to call recording, claiming the technology was unproven and unreliable. Even in 2010 the regulator did not accept these arguments.⁵

Since 2010 technology has improved substantially and the market has a number of systems that are capable of providing complete and reliable “on-site” and “cloud” solutions. In addition, costs have fallen.

Overall, the cost of mobile recording services has remained stable. However, the migration away from application based solutions to in-network recording has meant that the total cost of ownership has come down substantially. This is because the robust and unobtrusive nature of in-network recording has resulted in the day to day support and maintenance requirements becoming negligible.

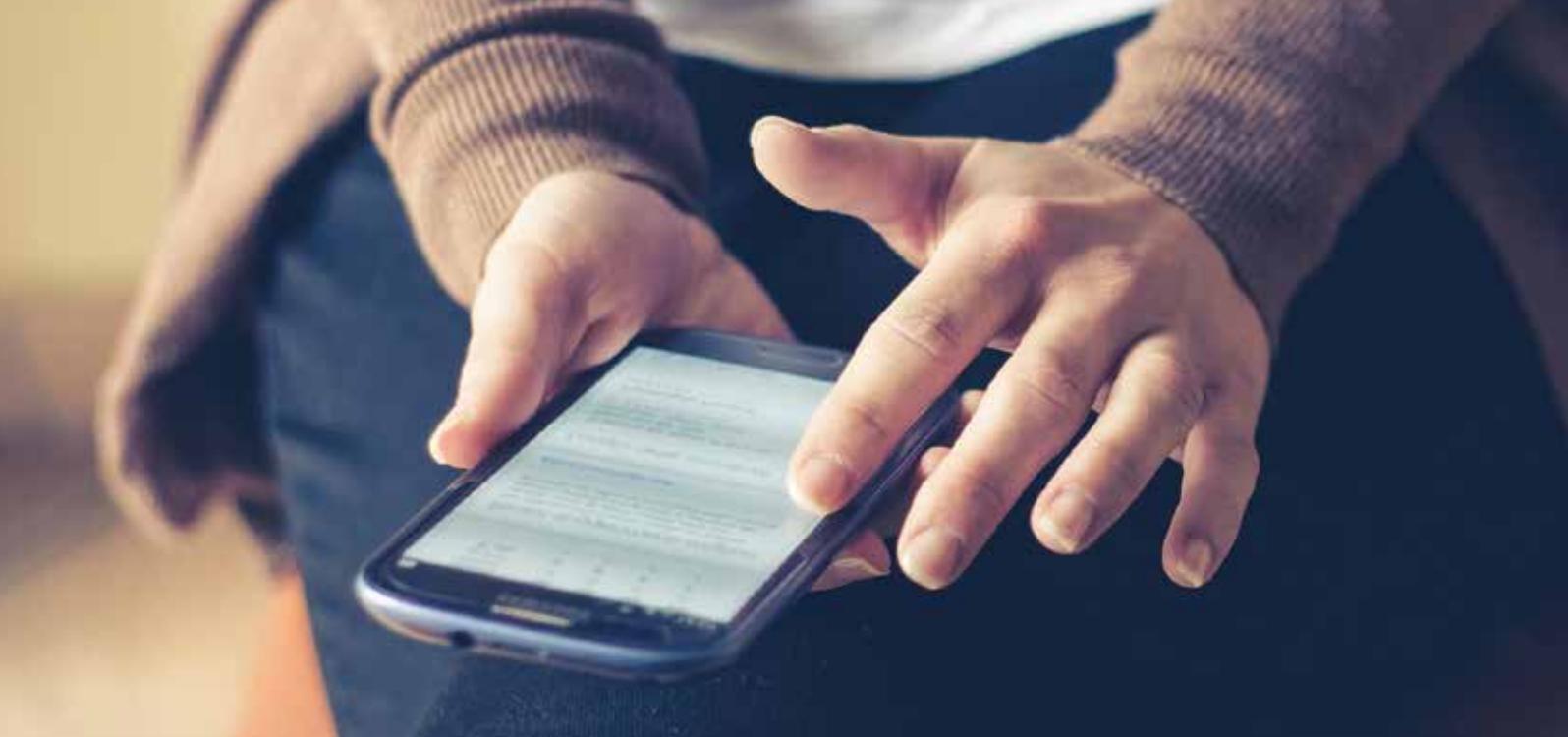
For EU firms that have a small UK branch office performing a low volume of Activities, MBP for the UK business might have been a reasonable response under MiFID I if other European offices were not obliged to record. But as all European offices are now obliged to record, then MBP will almost certainly fail as a “reasonable step”. This is because the constituency of people to be recorded has significantly increased and so MBP is no longer a proportionate response. The risks of failure are substantially costlier than the costs of purchasing call recording services, which are comparatively low. Also, economies of scale will apply and incremental costs to add users are small.

Similarly, the scope of MiFID II increases the number of Activities for which recording is now required. The same argument applies – the broader the population caught within the scope, the less likely that MBP is a reasonable step.

Furthermore, call recording extends to “conversations and electronic communications relating to (or intending to relate to) transactions concluded when dealing on own account and when providing client order services that relate to the reception, transmission and execution of orders.” So, the duty to record is much wider than just the conclusion of the transaction or providing client order services. The words “intending to relate to” extend the duty to conversations and communications even if they do not result in the performance of the activities. If the client’s intention is for the conversation to result in a transaction, then the call must be recorded even if the transaction is not concluded at this point. So, if a client calls for investment advice, but has not formed the intention to conclude a transaction, this does not require the call to be recorded. However, if the client subsequently calls stating that it wishes to proceed with the transaction, then an intention is formed and the call should be recorded.

⁴ PS10/17 paragraphs 2.26 – 2.27

⁵ PS10/17 paras 2.40 – 2.48



What happens if the intention is formed during the call?

The element of the call after formation of the intention must be recorded. However, that would lead to a partial recording of the call. The view of the European Securities and Markets Association (of significant importance) is that:

“The scope of the requirements requires firms to record the entirety of telephone conversations and electronic communications. This is because it is impossible to appreciate up front whether the conversation will lead to the conclusion of a transaction”.⁶

ESMA’s answer reinforces the argument that MBP is unwise. The idea that people will stop using their phones or other devices if they believe they were starting to discuss a potential transaction is naïve. It requires a high degree of personal awareness and discipline to self-police such behaviour. The opportunity for abuse is significant, especially if the caller has a personal incentive to complete the transaction. Returning to Paragraph 57 of the preamble to MiFID II, it is difficult to see how self-policing in this way really meets the requirements of the Directive. If the onus is on the investment firm to call record all relevant calls to increase investor protection and stop market abuse, then MBP falls short of the purpose of the Directive. If doing so on grounds of saving cost for an organisation that has regulated people across the EU carry out Activities, MBP falls even further short.

As for internal calls, ESMA expects firms to record all internal telephone calls or electronic communications regarding the handling of orders and transactions. It would not ordinarily expect persons carrying on back office functions to be caught by the requirements.

In the light of the Directive, the Policy Statement and the ESMA guidance, the safest course of action is to record all the calls of those who would be directly (i.e. client facing) involved in the conclusion of such transactions.

⁶ European Securities and Markets Authority – Question and Answers (ESMA35-43-349) Answer 8

EVER EVOLVING TECHNOLOGY.



Technology has evolved significantly in the last seven years. As noted, costs in this arena have fallen and technology is reliable. On-Site and Cloud-based solutions for data storage with enhanced security are now easily available at low cost.

Indeed, call recording has significant benefits. It improves surveillance and ensures that there is a real-time, objective record of what was said. This improves the ability of management and compliance to protect both the investor from market abuse and the investment firm from ill-founded claims.

MPB as the risk-based, proportionate and reasonable response to avoid call recording was dying. MiFID II is its coup de grace.

However - a warning from the call recording industry - time is passing by. The demand for call recording solutions is outrunning the availability of systems providers who can deliver in time. The time is now to set up your recording solution, to ensure that all relevant staff are trained and on-boarded. One thing is certain - inertia is not a solution.

Want to know more? Get in touch.



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