Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Extending MiFID II requirements for firms to record telephone conversations or electronic communications

Lead regulator: FCA

Date of assessment: 1 March 2018

Commencement date: 3 January 2018

Origin: Domestic extension of EU legislation

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of the UK

Brief outline of proposed new or amended regulatory activity

Existing FCA rules require certain firms to record telephone conversations and any electronic communications (henceforth referred to as 'taping') relating to transactions in financial instruments which are intended to lead to the conclusion of an agreement by the firm to deal with or on behalf of a client as principal or agent. Records of such conversations must be kept for 6 months. However, the existing FCA rules exempt discretionary investment managers[1] (DIMs) from the requirement when they are dealing with a firm whom they reasonably believe will be taping such conversations or communications in turn (e.g. brokers).

The Markets in Financial Instruments Directive II (MiFID II) introduced a similar taping obligation at EU level that applies to any relevant conversation that is intended to lead to a transaction, although it requires records to be kept for at least five years.

As part of the implementation of MiFID II, the FCA has taken a discretionary decision to expand the scope of taping requirements in terms of both types of firms and activities captured that goes beyond both that required by MiFID II and our current domestic regime. Specifically, our final rules extend requirements as follows:

- We have removed the current exemption for DIMs and extended the MiFID II taping requirements to them, such that we require firms providing portfolio management services to tape when placing or executing orders on behalf of clients, and hold records of relevant taped conversations for five years.

[1] A person who acts on behalf of a client to manage investments in an account or portfolio on a discretionary basis under the terms of a discretionary management agreement. This overlaps with the MiFID investment service of portfolio management. It involves a firm taking decisions on behalf of a client to buy and sell financial instruments within a portfolio on their behalf, based on a pre-agreed investment strategy or objectives outlined in a management agreement, without needing the client's approval for each decision or transaction.

- We applied MiFID II taping requirements to energy market participants (EMPs), oil market participants (OMPs), and firms conducting other non-MiFID commodity and exotic derivatives business. However, as these firms are currently subject to our domestic regime, the main impact will be the extension of the record keeping period from six months to five years to align with MiFID II.
- Required UK branches of third country firms to tape across the same scope of activities as MiFID II requires.

Taping is primarily intended to help detect instances of market abuse by firms or their employees, and / or potential non-compliance with other conduct of business requirements, and to assist FCA investigations into such issues. The FCA has extended the scope of taping to address gaps in our existing regime. Access to tapes from portfolio managers assists the FCA in carrying out our supervisory and enforcement investigations. Previously we have found that the exemption in FCA rules for DIMs has hampered such actions since tapes are needed from multiple brokers to reconcile the actions of a DIM. In addition, taping will allow DIMs to better monitor their own employees for potential abusive or inappropriate conduct and challenge a broker should a trading error occur.

Taping may also act as a general deterrent to firms or individuals from carrying out market abuse or misconduct. It can be a useful tool to enable firms to monitor compliance of their own staff, and in resolving potential disputes when receiving investment services from other firms (e.g. trading errors). For EMPs, OMPs, firms undertaking non-MiFID commodity and exotic derivatives business, and branches of third country firms, we believe there are equivalent risks of market abuse and a consequent benefit from taping their activities.

Which type of business will be affected? How many are estimated to be affected?

The firms most affected by these rules are DIMs who do not already tape. We expect approximately 448 such firms to be impacted.[2] Using the same evidence, we estimate that there are 596 DIMs who already tape. These firms will incur familiarisation and GAP analysis costs and, potentially, costs from the extended record keeping period.

For other non-MiFID firms or business, including OMPs, EMPs and third country branches, based on our CBA survey we think most of these firms already have taping systems in place. The extended record keeping period therefore represents the only potential additional cost, beyond familiarisation and GAP analysis costs, to these firms. Based on firm permissions data held by the FCA we estimate there are up to 20 firms classified as EMPs or OMPs and approximately 120 third country firms operating in the UK which could be affected by these rule changes.

Price base year	**Implementation date**	**Duration of policy (years)**	**Business Net Present Value**	**Net cost to business (EANDCB)**	**BIT score**
2016	3 January 2018	10	-37.4	4.3	21.7

Please set out the impact to business clearly with a breakdown of costs and benefits

The FCA sent out a questionnaire to around 5,000 FCA authorised firms in September 2015, asking for data to support its proposals for consultation in respect of all MiFID II changes. We followed this up with a second round of surveys. We then consulted on its proposals in a

[2] This figure was based on analysis of internal FCA data on firm permissions, in conjunction with questionnaire survey responses from firms (see below).

series of consultations during 2016 and 2017 on which we sought feedback on the proposals and the accompanying CBA.

In the section below we outline the costs and benefits to firms for the discretionary actions described above. The details presented below are drawn from underlying analysis conducted for the CBA in CP16/29 and which was finalised in PS17/14. It also includes additional calculations undertaken to estimate familiarisation, GAP analysis and storage costs for OMPs/EMPs, third country and DIMs who already tape for the purpose of this impact assessment. We did not estimate these additional costs as part of the CBA for our MiFID II implementation since, at that time, we assessed that they were likely to be of minimal significance for individual firms.

OMPs /EMPs, Third Country Firms and Discretionary Investment Managers (DIMs) who already tape

Familiarisation & GAP analysis costs

We expect the impacted firms to read and digest the relevant changes and subsequently perform a GAP analysis where they will familiarise themselves with the detailed requirements of the new rules and guidance, and check their current practices against these expectations.

Based on assumptions on the time required to undertake this analysis and the cost of this time to firms, we estimate that firms will incur an average cost of £304 to undertake this work.[3] In aggregate this indicates an overall cost of £0.2 million.[4]

Ongoing additional storage costs

As noted above, since these firms are already subject to our domestic taping rules for the relevant activity, the main additional obligation is to extend the time period for which they retain taping records from 6 months to 5 years.

For the purposes of this impact assessment we have sought to estimate these costs for OMPs/EMPs, third country firms and those DIMs who already tape. To estimate this we have used the figure from our broader taping CBA that an additional year's data storage costs £6 per user, based on the assumption that information is stored in a third party cloud (see following section). Accounting for the amount of additional data stored per user, over time as a result of changes to the rules indicates the following cost schedule for an individual user.

	Year 1	Year 2	Year 3	Year 4	Year 5 +
Years of additional data to store	0.5	1.5	2.5	3.5	4.5
Increase in yearly cost of storage per user	£3	£9	£15	£21	£27

[3] The average cost per firm varies due to differences in the distribution of the size of firms undertaking a given activity. Therefore the average costs for EMPs & OMPs is £250 per firm, the average costs for third country branches is £392 per firm and the average cost for DIMs who already tape is £165

[4] The assumptions used to estimate these costs have been derived from a research project on compliance costs that involved consultation with firms and trade bodies, discussions with vendors, a review of previous CBAs, internal FCA consultation, and desk-based research. To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs, as advocated by the HM Treasury Green Book.

To provide an aggregate cost figure we multiplied the cost schedule shown above by the number of individuals in customer dealing functions (CF30s) for each firm type.[5] Using this approach we estimate that the ongoing storage costs to firms is around £0.6 million per year from year five onwards.[6] However, this figure is likely to be an overestimate given that the costs of storage are likely to reduce further over time as computing capacity expands and cloud storage becomes cheaper.

Discretionary Investment Managers (DIMs) who do not already tape

For affected DIM firms, they would incur an initial one off cost for installing a new taping infrastructure, which would include service fees, connections, software and hardware. Our analysis indicates these one off costs range between £391 and £441 for telephone lines and installation as well as the first year's storage capacity.

Firms would also incur on-going costs associated with taping, storage, and *ex post* record retrieval of conversations. Our analysis indicates these ongoing costs range between £371 and £421 per user per year for all subsequent years beyond the first year.

As an illustration of our analysis of how these costs arise, we can consider an example of a firm needing to record the communication of one of its staff. Initial hardware, installation and first year storage capacity would cost between £391 and £441 per individual. This cost comprises a number of elements. Telephone lines and installation would account for £335 of this cost. If the lines are used on average 70% of an 8-hour working day, and speech is recorded at between 13 and 16 kbits per second in WAV format, each line will generate about 40 mb of data. Across a 260-day working year the total data generated per user is 10.4 GB. Assuming that a backup copy is kept and that this information is stored in a third party cloud, we estimate a cost of storage per user at £6 per year. We also include a further £50-£100 per user per year for maintenance and other associated miscellaneous expenses including staff costs. We estimate costs for the second and subsequent years will reduce to between £371 and £421 per user.[7]

To arrive at an aggregate cost figure we multiplied the estimated cost per individual by the total number of individuals affected (including an uplift, based on figures from previous analysis, that for every landline recorded, there will be 0.44 mobile phones recorded).

The number of relevant individuals working within DIM firms that would need to be taped was estimated at between 4,502 and 7,812. This was based on two methodologies:

- A bottom up estimate of 10.05 individuals per DIM impacted (448) which was based on average figures received through supervisory returns of the number of CF30s.
- A top down estimate derived from analysis conducted as part of the taping extension rules introduced in CP10/7 of the proportion of individuals who were exempt from the mobile taping extension as they were employees of DIMs, based on the total number of individuals originally estimated to be subject to the proposals without the exemption.

---

[5] 'CF30' refers to the controlled function under the FCA's approved persons regime that applies to any individual in a 'customer-dealing function', which include staff whose activities include dealing as principal or agent, or arranging deals in investments, in relation to retail or professional client business or acts in the capacity of an investment manager. It was therefore used as a reasonable proxy for the number of staff within a firm that would potentially need to be recorded. See: https://www.handbook.fca.org.uk/handbook/SUP/10A/10.html?timeline=True

[6] Data for CF30s was drawn from the FCA Register and was subsequently scaled for total firm numbers. Based on this approach we estimate that there are around 350 CF30s for OMPs & EMPs and 18,000 CF30s for Third Country firms. The number of CF30s for DIMs which already tape was obtained by multiplying the number of firms (596) by the average number of CF30s per firm based on supervisory returns (10.05). This suggests around 6,000 CF30s for these firms.

[7] These figures are based on combination of original analysis undertaken by the FSA prior to the introduction of a domestic taping obligation (as part of CP10/7), and engagement with a number of taping solutions providers and experts in the course of conducting CBA work for MiFID II. We also gained cost data from firms as part of our questionnaire on changes under MiFID II, although this was not a core component of our final estimates due to concerns over the consistency of figures provided when compared with information obtained from suppliers.

Using the combined lower and upper range figures presented above, for DIMs we estimate total cost of the extended rules as follows:

- One off costs between £2.5 million and £5.0 million; and
- Ongoing costs between £2.4 million and £4.7 million.
-

The changes proposed to the taping requirements for some firms are expected to benefit consumers. For example, these changes should help to resolve disputes faster. The benefits to consumers and society are likely to exceed costs to firms. However, under the Act, benefits to consumers and society are out of scope for impact assessments. These benefits were considered in our cost benefit analysis (CBA) prior to rule changes.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

The relevant FCA consultation paper for these provisions is: FCA, September 2016, CP16/29: Markets in Financial Instruments Directive II Implementation – Consultation Paper III, https://www.fca.org.uk/publication/consultation/cp16-29.pdf

The relevant FCA policy statement for these provisions is: FCA, July 2017, PS17/14: Markets in Financial Instruments Directive II Implementation – Policy Statement II, https://www.fca.org.uk/publication/policy/ps17-14.pdf

FSA, March 2010, Consultation Paper 10/7: Taping: Removing the mobile phone exemption http://www.fsa.gov.uk/pubs/cp/cp10_07.pdf

The European Commission published an impact assessment alongside its initial proposal for MiFID II, which included the taping proposals, which can be found here: https://ec.europa.eu/info/file/33578/download_en?token=EMcmdZOS