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SEC and CFTC Propose Identity Theft Red Flag Rules

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On March 6, 2012, the SEC and CFTC jointly proposed rules (the "Proposal") that would require registered broker-dealers, investment companies, investment advisers, commodity trading advisors, commodity pool operators and introducing brokers to develop and implement a written identity theft prevention program (a "Program") that is designed to detect, prevent and mitigate identity theft in connection with certain existing accounts or the opening of new accounts (the "Red Flag Rules"). The SEC and CFTC are also proposing guidelines (the "Guidelines") to assist entities in the formulation and maintenance of a Program that would satisfy the requirements set forth in the Proposal.

In 2007, the Federal Trade Commission ("FTC") adopted rules and guidelines regarding the detection, prevention and mitigation of identity theft (the "FTC Red Flag Rules"). The Proposal, if adopted, would not contain new requirements not already in the FTC Red Flag Rules, nor would it expand the scope of those rules to include new entities that were not already previously covered by the FTC Red Flag Rules. Thus, if a broker-dealer, registered investment company, registered investment adviser, commodity trading advisor, commodity pool operator or introducing broker was subject to the FTC Red Flag Rules, they would be subject to the Red Flag Rules.

The SEC and CFTC were required to issue the Proposal pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Dodd-Frank provides for the transfer of rulemaking responsibility and enforcement authority with respect to identity theft red flag rules to the SEC and CFTC with respect to entities under their respective jurisdiction. The Proposal is the SEC's and CFTC's version of the FTC Red Flag Rules.

This summary focuses on the SEC version of the Red Flag Rules. The CFTC version of the Red Flag Rules is substantially similar. The SEC version of the Red Flag Rules will be known as Regulation S-ID and would be added after Regulations S-P and S-AM when codified.

Comments on the Proposal are due May 7, 2012.

What Triggers the Requirement to Adopt a Written Identity Theft Prevention Program?

Each "financial institution" or "creditor" that offers or maintains one or more "covered accounts" must develop and implement a written Program that is designed to detect, prevent and mitigate identity theft in connection with the opening of a covered account or any existing covered account. For purposes of the Proposal:

- "Financial institution" means a registered broker-dealer, registered investment company or registered investment adviser;
- "Creditor" generally means a person that regularly and in the course of business advances funds to or on behalf of a person, based on an obligation of the person to repay the funds or repayable from specific property pledged by or on behalf of the person. The proposed definition of "creditor" would include brokers or dealers offering margin accounts, securities lending services and short

selling services. Investment advisers would not be treated as creditors solely because they bill in arrears;

- "Covered Account" means (i) an "account" that a financial institution or creditor offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, such as a brokerage account or mutual fund account that permits wire transfers or other payments to third parties and (ii) any other "account" that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft, including financial, operational, compliance, reputation or litigation risks; and
- "Account" is defined as a continuing relationship established by a person with a financial institution or creditor to obtain a product or service for personal, family, household or business purposes. "Account" includes a brokerage account, a mutual fund account and investment advisory account.

Under the Proposal, each financial institution or creditor would be required to periodically determine whether it offers or maintains covered accounts. As part of this determination, a financial institution or creditor would be required to conduct a risk assessment that takes into consideration (i) the methods it provides to open accounts, (ii) the methods it provides to access its accounts and (iii) its previous experience with identity theft. The proposing release notes that a financial institution or creditor should consider whether a reasonably foreseeable risk of identity theft may exist in connection with accounts it offers or maintains that may be opened or accessed remotely or through means that do not require face-to-face contact, such as through the internet or by telephone. Even if a financial institution or creditor determines that it does not need a Program, it needs to periodically reassess that decision to account for changes in its business model, accounts or identity theft experience.

What Elements Must a Written Identity Theft Prevention Program Contain?

A Program must include reasonable policies and procedures to:

- Identify relevant "red flags" for covered accounts that the financial institution or creditor offers or maintains and incorporate those red flags into the Program;
- Detect red flags that have been incorporated into the Program;
- Respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and
- Ensure the Program (including the red flags determined to be relevant) is updated periodically, to reflect changes in risks to customers and to the safety and soundness of the financial institution from identity theft.

"Red flag" means a pattern, practice or specific activity that indicates the possible existence of identity theft. The Guidelines include a number of examples of red flags.

Like anti-money laundering programs, the Program adopted by a financial institution must be appropriate to the size and complexity of the entity and the nature and scope of its activities. The Program must be approved by the board of directors or senior management, provide for oversight of the Program by the board or senior management, provide for appropriate training and provide for appropriate and effective oversight of service provider arrangements.

A Few Final Thoughts

Although registered broker-dealers, registered investment companies and registered investment advisers have been subject to FTC Red Flag Rules and the FTC's enforcement authority thereunder since 2007, there was historically some industry confusion regarding the circumstances under which the FTC Red Flag Rules applied, especially with respect to registered investment advisers. The Proposal aims to address some of the issues raised by the FTC Red Flag Rules given that the FTC version was written for a more general audience and was not specific to the securities industry. The SEC and CFTC note that most of the entities over which they have jurisdiction are likely to already be in compliance with the FTC Red Flag Rules, to the extent that these entities' activities fall within the scope of the FTC Red Flag Rules. The Proposal does, however, contain examples and minor language changes designed to help guide entities under the SEC's and CFTC's jurisdiction in complying with the rules, and the SEC and CFTC anticipate that the Proposal, if adopted, may help some entities discern whether and how the rules apply to their circumstances.

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