



Risk Management Update July 2009

NEWS UPDATE: RED FLAG RULE POSTPONED (AGAIN)

On July 29, 2009, the Federal Trade Commission delayed until November 1st the “red flag” rule designed to prevent customer identity theft. In Core Compliance & Legal Services, Inc.’s (“CCLS”) May 2009 Risk Management Update, we discussed the proposed “Red Flag Rule”¹ which was initially set to go into effect in November 1, 2008, May 1, 2009 and then more recently, on August 1, 2009. While these rules only apply to *financial institutions* and *creditors* maintaining *covered accounts*, CCLS provided guidance on the types of investment firms that could fall within these definitions.

- Broker-dealers that extend margin to customers;
- Broker-dealers that offer check-writing features as part of their brokerage accounts;
- Investment advisers that charge advisory fees in arrears;² and/or
- Firms that include accrual of incentive fees or arranging funds for clients to buy securities on margin.³

The Red Flag Rule requires all affected firms to develop and implement written programs for the detection, prevention, and mitigation of identity theft.

Until recently, neither FINRA nor the SEC provided guidance on how they would enforce the Red Flag Rule, not to mention whether they would expect broker-dealers and investment advisers to comply with them. Fortunately, the FTC has stated it will issue additional guidance on how to comply with the rule shortly.⁴

In order to provide additional assistance, on July 1, 2009, FINRA issued its Identity Theft Prevention Program (“ITPP”) Template.⁵ The introduction to this Template, FINRA states that if a broker-dealer is subject to the Red Flag Rule, “[we] expect it to have policies and procedures in place to comply with them.”⁶

Within the ITPP, FINRA outlines the provisions that it will expect to see. The following highlights the key provisions of the template:

- *An identification of who is responsible for the approval, oversight, implementation and administration of the ITPP.* The Template suggests that this person should be a member of senior management. In most cases, this will probably be the firm’s Chief Compliance Officer (“CCO”).
- *An analysis of the existing policies and procedures which have been considered and amended to prevent inconsistencies or duplication.* When

carrying out this task, firms should pay particular attention to their Anti-Money Laundering (“AML”) Program and Privacy Policies and Procedures, as these are the areas where a crossover is most likely.

- *A description of the risk factors analyzed by the firm and a list of Red Flags indentified when conducting this analysis.* FINRA’s list is a direct copy of the FTC’s twenty-six suggested Red Flags, contained within Supplement A to Appendix J of the Red Flag Rule. In practice, a firm will want to omit or include further Red Flags based upon its business model and associated risk factors.
- *A description of the procedures to be followed to detect each Red Flag.* FINRA has provided one suggested procedure for each of the twenty-six suggested Red Flags. These suggestions are generally practical and useful. For example, in order to detect the Red Flag of two customers having the same social security number, FINRA suggests cross-referencing any social security number provided by a new customer against all social security numbers previously provided by other customers. However, fore each Red Flag, FINRA invites the firm to describe other detection steps the firm will take. Consequently, FINRA will expect firms to do more than just copy their suggestions.
- *A description of the procedures to be followed to prevent and mitigate identity theft once a Red Flag has been detected.* The Template contains two sets of alternative procedures to be used depending upon whether the Red Flag is detected in connection with a customer applying to open an account or in connection with an unauthorized person attempting to access a customer’s account. Notably, FINRA’s suggested procedures are of a practical, common sense, nature. For example, in the case of an unauthorized access Red Flag, the Template provides that the firm should amongst other things, monitor, limit, or temporarily suspend activity in the account and then contact the customer.
- *A description of all clearing firms and other service providers that perform activities in connection with customer accounts and a statement that these firms have their own ITPPs in place.* This appears to impose a due diligence requirement on firms, which could be onerous depending on the number of outside parties a firm does business with in this way.

It is important that to note that as useful as the Template is, by FINRA’s own admission, it is not comprehensive and as such, should be expanded upon and tailored to the individual needs of each firm.

In conclusion, with the extension of the Red Flag Rule implementation date, firms that are subject to the Red Flag Rule should ensure that they have adopted ITPPs by this deadline. Affected broker-dealers should pay particular attention to this requirement

given FINRA's expectations of compliance. Firms also may wish to consider using the FINRA Template as an initial step in developing their own ITPPs. CCLS will provide updates once the FTC has provided additional guidance on how financial institutions or creditors that offers covered accounts can comply with the rule. For more information on whether you could be affected by the Red Flag Rule, please feel free to contact us.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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¹ FTC Business Alert, New 'Red Flag' Requirements for Financial Institutions and Creditors Will Help Fight Identity Theft, *available at* <http://www.ftc.gov/bcp/edu/pubs/business/alerts/alt050.shtm>.

² "The FTC signaled that it intends to apply the rule broadly and that it could apply to investment advisers, particularly if they bill clients for services or use consumer reports to evaluate prospective employees, according to an alert issued by the ACA Compliance Group of Washington." Sara Hansard, "Red Flag Rule to Prevent Customer Identity Theft Postponed," July 29, 2009, <http://www.investmentnews.com>, July 30, 2009.

³ Id. The FTC has stated that some companies, particularly small businesses, are not certain what rules apply to them or what their obligations are. This may include investment advisers.

⁴ Id.

⁵ FTC FACT Act Red Flags Rule Template, *available at* <http://www.finra.org/Industry/Issues/CustomerInformationProtection/p118480>.

⁶ Id.