



Risk Management Update May 2009

THE RED FLAG RULES *REVISITED*

In our December 2008 Risk Management Update, Core Compliance & Legal Services, Inc. (“CCLS”) discussed the Federal Trade Commission’s (“FTC”) proposed “Red Flag Rules.”¹ As a brief recap, the “Red Flag Rules” require *financial institutions* and *creditors with covered accounts* to develop and implement written programs for the detection, prevention, and mitigation of identity theft.² Although the Red Flag Rules took effect as of November 2008, the FTC has delayed the enforcement of the rules until August 2009.

Our previous Risk Management Update indicated that many investment firms may fall within the application of the Red Flag Rules even though they are not directly regulated by the FTC. In response to inquiries we received, CCLS reached out to staff members at FINRA and the SEC to obtain additional guidance on the applicability of the Red Flag Rules to broker-dealers and registered investment advisers respectively.

From their responses, it appears that both regulators are particularly focused on this area. There appears to be an overlying expectation for investment firms covered by the Red Flag Rules to have identity theft prevention programs in place as a part of their overall fiduciary duties to establish reasonable internal controls. Perhaps an analogous comparison to this requirement is the expectation for registered investment advisers to have established anti-money laundering policies, even though Rule 206(4)-7 may not mandate this as a required written policy and procedure.

While FINRA has identified compliance with the Red Flag Rules as an examination priority for 2009,³ neither the SEC nor FINRA have given any guidance as to what type of firms they will expect to comply with the Red Flag Rules. Instead, the regulatory bodies have indicated that it is ultimately up to each individual firm to determine whether or not the Red Flag Rules apply to them.

In order to be subject to the Red Flag Rules, a securities institution must first fall within the Fair and Accurate Credit Transactions Act of 2003’s definition of either a “creditor” or a “financial institution.”

“Creditor” is defined as an entity that is regularly involved with the extension, renewal or continuation of credit and includes any and all entities that regularly allow for deferred payment for goods or services rendered.⁴ Both broker-dealers and registered investment advisers could fall within this definition. Broker-dealers often allow customers to trade on margin, and many registered investment advisers charge their advisory fees in arrears. On the other hand, a “financial institution” includes banks, credit unions, savings and loans, along with any other person holding a transaction account either directly or

indirectly belonging to a consumer.⁵ For this purpose, a “transaction account” means a deposit or account on which the depositor or account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or other similar items for the purpose of making payments or transfers to third persons or others.⁶ Certain custodial broker-dealers could fall within this definition, particularly those retail firms who offer checking accounts to their customers.

With this in mind, investment advisers and broker-dealers should carefully consider whether any part of their business model falls within any of these definitions, even inadvertently. If so, they should consider modifying their business plans accordingly or begin developing identity theft programs to comply with the Red Flag Rules by August 2009.

To help you determine whether your firm may be subject to the Red Flag Rules, we suggest that you take the following self-assessment quiz to determine whether your firm’s falls within the FACT Act’s definition of either “creditor” or “financial institution” holding “transaction accounts.”

Does your firm:

- Yes No Allow clients to trade on margin?
- Yes No Provide investment advisory or brokerage services and bill in arrears?
- Yes No Maintain custodial accounts which allow clients to make multiple account withdrawals for the purposes of payments and transfers to third parties?
- Yes No Have any affiliation with another business which, if asked would answer “yes” to any of the above questions?
- Yes No Have any affiliation with another business which might fall within the traditional definition of a Creditor or a Financial Institution?

If you answered “yes” to any of the first three questions, FINRA or the SEC may expect your firm to comply with the Red Flag Rules. If you answered “yes” to any of the last two questions, your firm may need to implement identity theft programs, but this will depend on the precise nature of your affiliation. The closer the affiliation, the likelier this will be. Should your firm have a risk management or compliance committee, think about addressing this topic at your next meeting.

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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issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

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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 16 C.F.R. § 681.2.

³ 2009 FINRA Examination Priorities Letter, *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p118113.pdf>.

⁴ *Supra*, note 2 at subd. (b)(5).

⁵ 15 U.S.C. § 1681a(t).

⁶ 12 U.S.C. § 461(C).