SEC and CFTC Jointly Adopt Rules Requiring Certain Investment Advisers and Other Regulated Entities to Establish Programs to Combat Identity Theft

May 1, 2013

BACKGROUND

On April 10, 2013, the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") jointly adopted rules and guidelines that require certain entities they regulate to establish programs to combat identity theft (the "Rules").[1] The SEC's Rules apply to any SEC-registered investment adviser, investment company[2] or broker-dealer that meets the definition of a "financial institution" or "creditor" under the FCPA and the CFTC's Rules apply to commodity pool operators, commodity trading advisors and futures commodity merchants, among other entities it regulates, all to the extent such an entity "offers or maintains one or more covered accounts."

The Rules are substantially similar to rules and guidelines on detecting, preventing and mitigating identity theft adopted in 2007 (the "2007 Rules") by several federal agencies, including the FTC and banking regulators and that applied to many of the entities regulated by the SEC and the CFTC.[3] However, as noted in the release adopting the Rules (the "Release"), the SEC staff anticipates that the examples set forth in the Release of circumstances in which certain entities, particularly investment advisers that manage accounts belonging to individuals, may fall within the scope of the Rules could lead some of these entities that had not previously complied with the 2007 Rules to now determine that they should comply with the Rules.

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[1] The Rules were adopted in accordance with the amendment made by the Dodd-Frank Wall Street Reform and Consumer Protection Act to the Fair Credit Reporting Act of 1970 (the "FCRA") to transfer identity theft rulemaking responsibility and enforcement authority from the Federal Trade Commission (the "FTC") to the SEC and the CFTC for the entities they regulate.

[2] The Rules also apply to business development companies and employees' securities companies, which typically do not register as investment companies but are regulated by the SEC.

[3] Congress had amended the FRCA in 2003 to require these agencies to adopt such rules and guidelines. At that time the FCRA did not include the SEC or CFTC among the agencies required to adopt identity theft rules, but instead gave the FTC authority to adopt and enforce identity theft rules related to entities regulated by the SEC and CFTC.

SCOPE OF THE RULES

For the entities identified in the Rules, the critical inquiry is whether they "offer or maintain covered accounts." Based upon the 2007 Rules, the Rules generally define covered accounts as transaction accounts owned by individual(s). The SEC Rules cite a brokerage account and a mutual fund account that permits wire transfers or other payments to third parties as examples of covered accounts, while the CFTC Rules cite a margin account as such an example. As noted above, the Release provides further illustrations of entities that could fall within the scope of the Rules, including an investment adviser who has the ability to direct payments from accounts belonging to individuals to third parties, whether upon the individuals' instructions or as agent for the individuals, and even where the investor's assets are physically held by a qualified custodian but the adviser has the authority to withdraw money from the account and direct the third party payments. The Release also provides guidance with respect to private fund advisers by indicating that if an individual invests in a private fund and the fund's adviser has the authority, pursuant to an arrangement with the private fund or the individual, to direct such individual's investment proceeds (e.g., redemptions, distributions, dividends, interest) to third parties, even upon instructions received from the individual, that adviser would fall within the Rules' scope. On the other hand, the Release clarifies that an investment adviser with authority to withdraw money only to cover its own advisory fees, and not to make payments to third parties, would not fall within the Rules' scope.

Non-financial institutions may still be subject to the Rules if they are creditors. The Rules, again based upon the 2007 Rules, generally define a creditor as one that regularly and in the course of business advances funds to another party based upon that party's obligation to repay the funds directly or through specifically pledged property. Although this definition is unlikely to include investment advisers, since they do not generally advance funds to investors and clients, it would include a private fund adviser that regularly and in the ordinary course of business lends money, short term or otherwise, to permit investors that are individuals to make an investment in the fund. It may also include commodity trading advisers that regularly extend credit. Specifically excluded from coverage is a creditor that advances funds on behalf of a person for expenses incidental to a service provided by the creditor to that person.

Financial institutions and creditors do not have to implement an identity theft program if they determine after a preliminary risk assessment that the accounts they hold do not pose a reasonably foreseeable risk of identity theft, for instance if they are an investment adviser but do not manage accounts belonging to individuals. However, this initial conclusion must be reassessed periodically.

REQUIREMENTS OF THE RULES

Entities that fall within the scope of the Rules must implement a program containing policies and procedures designed to:

- identify relevant types of identity theft red flags
- detect the occurrence of those red flags
- respond appropriately to detected red flags
- train staff on identity theft policies and procedures
- periodically update the identity theft program

The Rules allow for flexibility in how entities identify and manage identity theft risks that are specific to their business. The program must be appropriate to the size and complexity of the entity and the nature and scope of its activities. Categories of red flags that should be considered include alerts, notifications, or other warnings received from consumer reporting agencies or service providers, suspicious identifying information and or documentation, suspicious activity related to an account and notice from customers, victims of identity theft, law enforcement authorities or other persons regarding possible identity theft.

The identity theft program must be adopted by an entity's board of directors or senior management, to the extent it does not have board, and overseen by the board or a designated senior management employee, which can be the entity's Chief Compliance Officer.

The Rules will become effective on May 20, 2013 and the compliance date is November 20, 2013.

For the Release, see http://www.sec.gov/rules/final/2013/34-69359.pdf

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