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SEC and CFTC Adopt "Red Flag" Identity Theft Rules

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The SEC and the CFTC recently issued final rules requiring certain regulated entities that qualify as either "financial institutions" or "creditors" to adopt programs to identify and address the risk of identity theft (so-called "red flag rules"). The final rules went into effect on May 20, 2013, and all affected SEC- and CFTC-regulated entities are required to be in compliance with them by November 20, 2013. The following is a brief analysis of Regulation S-ID (the SEC's new red flag rules) and Subpart C (the CFTC's new red flag rules) and their potential impact on private fund advisers.

The red flag rules grew out of a regulatory initiative mandated by Congress in 2003 that required various Federal regulatory agencies (including the FTC, but not the SEC or the CFTC) to jointly issue regulations requiring the entities under their respective jurisdictions to adopt identity theft detection programs. Rules were adopted in accordance with this mandate in 2007, requiring all "financial institutions" and "creditors" to assess their risks of identity theft and to adopt a program designed to detect and address instances of identity theft. At the time, jurisdiction for enforcement of these rules with respect to brokers, investment companies, investment advisers, commodity pool operators, commodity trading advisers and other entities regulated by the SEC and/or the CFTC was assumed by the FTC.

Under Dodd Frank, responsibility for enforcing the red flag rules against SEC- and CFTC-regulated entities was transferred from the FTC to the SEC and the CFTC, respectively. The adoption of Regulation S-ID and Subpart C implements this change. In essence, the SEC and the CFTC have adopted the existing red flag rules in their current form and added some interpretive guidance as to how the rules might apply to the various entities under their jurisdiction. The substantive requirements of the rules have not changed.

In the Adopting Release, the SEC and CFTC have made it clear that they consider private fund advisers to be within the potential scope of the new rules. Indeed, the SEC provides a number of specific hypothetical examples of circumstances in which private fund advisers could find themselves subject to the rules. It may be possible for many private fund advisers to avoid becoming subject to the red flag rules by conducting their business activities so as to avoid falling within the definition of either a "financial institution" or a "creditor". However, these terms have been interpreted quite broadly by the regulatory authorities, so private fund advisers that have not adopted identity theft detection programs should be careful that they do not inadvertently become subject to the red flag rules.

An investment adviser will be considered a "financial institution" under the red flag rules if it directly or indirectly holds "transaction accounts" belonging to a "consumer".

- A "consumer" is defined under the red flag rules as any individual. High net worth individuals that qualify as accredited investors, qualified clients or qualified purchasers will still be considered "consumers" for purposes of the red flag rules.
- A "transaction account" is defined as an account in which "the account holder is permitted to make withdrawals by negotiable or transferrable instrument, payment orders of withdrawal, telephone transfers, or similar items for the purposes of making payments or transfers to third persons or others." According to the SEC, this includes investment advisory accounts where the investment adviser is permitted to direct payments or transfers out of those accounts to third parties, but does not include accounts where the adviser only has the power to withdraw its own fees directly from the account. However, the SEC specifically cautions private fund advisers that "if an individual invests money in a private fund, and the adviser to the fund has the authority, pursuant to an arrangement with the private fund or the individual, to direct such individual's investment proceeds . . . to third parties, then that adviser would indirectly hold a transaction account."

Private fund advisers should carefully review their business practices to determine if they might fall within the definition of a "financial institution". Private fund advisers may be able to avoid being treated as a "financial institution" under the red flag rules if they have no investors that are individuals, or they do not accept instructions from investors to distribute investment proceeds to any parties other than the direct investors in their funds. However, if a private fund adviser has a single natural person who is a client/investor and who directly or indirectly holds a "transaction account" with the adviser, the red flag rules will require the adviser to assess the risk of identity theft and adopt an appropriate identity theft detection program to address this risk for all of the adviser's accounts, not just those for individuals.

Investment advisers may also fall within the scope of the red flag rules if they are considered "creditors". A "creditor" is defined to include any person "that regularly and in the ordinary 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 on behalf of the person."

- At one point, the FTC took the interpretive position that any service provider that charged fees in arrears fell within the definition of a "creditor" under the red flag rules. In response to strong objections from various industry trade organizations, however, Congress passed a law in 2010 to exclude from the scope of the red flag rules any creditor that "advances funds on behalf of a person for expenses incidental to the services provided by the creditor to that person." The legislative history makes it clear that Congress intended to exclude from the scope of the rules service providers that bill in arrears for their services.
- According to the SEC, however, investment advisers may still be considered "creditors" if they "advance funds that are not for expenses incidental to services provided by that adviser." Beyond stating that this does not include investment advisers who charge fees in arrears, the SEC does not elaborate on what types of expenses may be considered "incidental" to the services being provided by an investment adviser. However, the SEC does specifically caution private fund advisers that "a private fund adviser that regularly and in the ordinary course of business lends money, short-term or otherwise, to permit investors to make an investment in the fund, pending the receipt or clearance of an investor's check or wire transfer, could qualify as a creditor."

Private fund advisers should carefully review their business practices to determine if they might fall within the scope of the definition of a "creditor". It seems clear that the practice of charging advisory fees in arrears does not turn an investment adviser into a creditor. Likewise, the advance payment of expenses for consultants, experts and other costs incidental to the operation of a private fund is unlikely to raise issues under the red flag rules. On the other hand, a practice of advancing funds on behalf of investors in connection with capital calls would, at minimum, appear to raise questions.

If a private fund adviser falls within the definition of either a "financial institution" or a "creditor", then the red flag rules require the adviser to periodically assess whether it offers or maintains "covered accounts", which are broadly defined as any account where there is a reasonably foreseeable risk to customers of identity theft. For all such covered accounts, the adviser is required to establish and implement a written identity theft detection program "appropriate to the size and complexity of the financial institution or creditor and the nature and scope of its activities." Such programs must include at minimum the following elements:

- Identification of relevant "red flags" that may be indicators for potential identity theft;
- Detection of the relevant red flags;
- Appropriate responses to any red flags that are detected; and
- Periodic review and updates to the identity theft program.

In establishing its identity theft program, an adviser is required to consider a lengthy set of "guidelines" designed to assist it in the design and implementation of a program that satisfies the requirements of the red flag rules.

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As noted above, the only change to current law resulting from the adoption of the red flag rules by the SEC and the CFTC is to transfer jurisdiction for the enforcement of the red flag rules against SEC- and CFTC-regulated entities to those agencies. Technically speaking, therefore, the legal obligations that private fund managers may have to assess their identity theft risks and to adopt programs to address them have not changed. However, with the SEC's and CFTC's current focus on the private fund industry and the greater enforcement resources that are available to those agencies, private fund advisers can expect that this issue will receive greater regulatory attention than has previously been the case. As such, private fund advisers would be well-advised to review their business activities in light of the adoption of the red flag rules to determine if they might fall within the scope of the rules.

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