Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS MARCH 8, 2012

SEC and CFTC Propose Identity Theft Rules

The Securities and Exchange Commission and Commodity Futures Trading Commission (the "Commissions") recently proposed rules and guidelines that would require certain entities to develop and implement a written identity theft prevention program that is designed to detect, prevent, and mitigate identity theft in connection with certain existing accounts or the opening of new accounts. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended certain federal laws to require the Commissions to jointly adopt rules and issue guidelines for "financial institutions" and "creditors" regarding identity theft. A "financial institution" generally includes any person that, directly or indirectly, holds a transaction account belonging to a consumer. A "creditor" generally includes a person that regularly in the course of business advances funds to or on behalf of a person based on an obligation to repay the funds. The proposed rules would cover "financial institutions" and "creditors" that are:

CFTC-Registered Entities
- futures commission merchants (FCMs)
- retail foreign exchange dealers
- commodity trading advisors (CTAs)
- commodity pool operators (CPOs)
- introducing brokers (IBs)
- swap dealers
- major swap participants

SEC-Registered Entities
- broker-dealers
- others registered under the Securities Exchange Act of 1934 (e.g., NRSROs, SROs, municipal advisors, municipal securities dealers)
- investment companies
- investment advisers

Some of the entities listed above are less likely to be covered by the proposed rules because they do not hold transaction accounts of customer. For example, this might be especially the case for investment advisers and municipal advisors. The proposed rules are substantially similar to 2007 rules under the Fair Credit and Reporting Act adopted by the Federal Trade Commission and other agencies. The joint SEC/CFTC release is available at http://www.gpo.gov/fdsys/pkg/FR-2012-03-06/pdf/2012-5157.pdf.

Identity Theft Prevention Programs

Each covered entity that offers one or more covered accounts would be required to develop and maintain a program that is designed to detect, prevent, and mitigate identity theft. A covered entity may incorporate existing policies, procedures, and other arrangements that control reasonable foreseeable risks to customers or to the safety and soundness of the financial institution or creditor from identity theft. The program would apply to any new or existing covered account. The written identity theft prevention program would be required to include reasonable policies and procedures to:

- Identify relevant red flags;
- Detect the occurrence of red flags;

- Respond appropriately to the detected red flags; and
- Periodically update the program.

Identifying and Detecting the Occurrence of Relevant Red Flags

The Commissions define "red flags" to mean a pattern, practice, or specific activity that indicates the possible existence of identity theft. The list of factors that a financial institution or creditor should consider (as well as examples) are included in the proposed guidelines. The proposed guidelines also include a non-comprehensive list of examples of red flags that financial institution or creditor may experience and provide examples of various means to detect red flags but do not provide a specific method of detection.

Responding to Detected Red Flags

The proposed rules would require covered financial institutions and creditors to have reasonable policies and procedures to respond appropriately, based on the degree of risk, to any red flags that are detected. The proposed guidelines set out a list of aggravating factors and examples that a covered financial institution or creditor should consider in determining the appropriate response. The proposed guidelines also provide several examples of appropriate responses, such as monitoring a covered account for evidence of identity theft, contacting the customer, changing passwords, security codes, or other security devices that permit access to a covered account.

Updating the Identity Theft Prevention Program

The proposed rules would require each financial institution or creditor to periodically update its program (including relevant red flags) to reflect changes in risk and safety. The proposed guidelines would include a list of factors on which a financial institution or creditor could base the updates to its program.

Submitting Comments

You may submit comments on the proposed rules by submitting a hard copy, by sending an e-mail to rule-comments@sec.gov with File Number S7-02-12 in the subject line or at this link. You may submit comments on the proposed rule May 7, 2012.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.