Red Flag Rules Likely Inapplicable to Advisers and CPOs but Must be Addressed

The Dodd-Frank Wall Street Reform and Consumer Protection Act reallocated responsibility for enforcement of rules relating to accounts that present a risk of identity theft (the so-called identity theft “red flag” rules) to the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) from the Federal Trade Commission (FTC), among others, for entities under their jurisdiction. The SEC and the CFTC recently adopted rules that are substantially similar to those previously adopted by the FTC, but the SEC and CFTC provided useful guidance relating to their registrants, especially registered investment advisers to private funds. The rules were effective May 20, 2013, with a compliance date of November 20, 2013.

Most investment advisers to funds, commodity trading advisors (CTAs) and commodity pool operators (CPOs) will not be subject to identity theft red flag rules, but they may still need to demonstrate that they have contemplated the requirements of the rules and determined that the risk of identity theft is minimal. The following flowchart summarizes the analysis of whether the rules are applicable.

START HERE: Do you maintain any account for an individual (i) for personal, family or household purposes that is designed to permit multiple payments to third parties or (ii) for which there is a reasonable risk to customers of identity theft or to the safety and soundness of the financial, operational, reputation or litigation risks (each of the above accounts, a “covered account”)?

Do you as adviser or CPO (not the fund you manage) regularly extend, renew or continue credit, or arrange for or participate in the decision as an assignee of a creditor to extend, renew or continue credit?

The investment adviser or CPO must design a reasonable program to identify, detect and respond to red flags that is approved by senior management and that is appropriate to the size and complexity of the financial institution and the nature and scope of its activities, and to update the program periodically to address evolving risks.

The financial institution or creditor must periodically determine whether it offers covered accounts by examining:
  - methods of opening accounts
  - methods of accessing accounts
  - previous experience with identity theft.

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The SEC and CFTC’s rules apply only to financial institutions (i.e., those registered investment advisers, CPOs, CTAs, futures commission merchants or broker-dealers that hold transaction accounts) and creditors (as further described below). The SEC stated that registered investment advisers that “have the ability to direct payments from accounts belonging to third parties upon the individual's instructions” are likely to be subject to the risks of identity theft and, therefore, will be required to adopt policies. For registered investment advisers to private funds, if an investor can direct the proceeds of redemptions to a third-party account, the adviser would be considered to hold transaction accounts and thus the adviser would be subject to the identity theft rules. Many advisers to private funds and CPOs, however, have policies that require any withdrawal proceeds to only be paid to the account from which the subscription was made in order to reduce the risk of money laundering and will not, therefore, hold transaction accounts.

An adviser, CTA or CPO could also be subject to the rules if it is a creditor that regularly and in the ordinary course of business advances funds. The SEC provided guidance that an investment adviser to a fund is unlikely to be deemed to be a creditor unless it extends credit to investors in connection with their investments in the funds, pending the receipt of clearance of an investor’s check or wire transfer. The advised private fund’s borrowing from third-party credit facilities pending receipt of investor contributions, however, will not cause the registered investment adviser to be a creditor that must develop policies, as the investment adviser is not acting as the lender. The fund’s status as a creditor that regularly and in the ordinary course of business advances funds does not cause the adviser to the fund to be subject to the identity theft rules.

If any registered investment adviser, CTA or CPO offers transaction accounts or is a creditor, then it will need to determine on a periodic basis whether it maintains covered accounts that would require it to adopt policies. In its periodic review, an adviser, CTA or CPO should specifically examine the methods it uses to open accounts, the methods it uses to provide access to its accounts and any experiences with identity theft during the past period.

Each registered investment adviser, CTA and CPO that offers covered accounts is required to develop and implement a written program that is designed to detect, prevent and mitigate identity theft in connection with its covered accounts that is appropriate to the financial institution or creditor. Each registered investment adviser, CTA or CPO with such a red flag program must update its program on a periodic basis to ensure that it keeps pace with changes in identity theft methods. While identity theft red flags could be outsourced, persons required to develop programs must oversee the implementation of programs and will be responsible for the implementation of the program.

The SEC and CFTC adopted guidelines to assist those persons who are required to adopt programs to develop compliance policies. The SEC guidelines are available here and the CFTC guidelines are available here. The SEC’s rules are contained in new Regulation S-ID (17 C.F.R. § 248.201 and 202), and the CFTC’s rules are contained in Part 162 of its regulations (17 C.F.R. § 162.30 et.seq.).
Contact Information

If you have any questions regarding this alert, please contact:

David M. Billings
dbillings@akingump.com
44.20.7012.9620
London

Prakash H. Mehta
pmehta@akingump.com
212.872.4370
New York

Kelli L. Moll
kmoll@akingump.com
212.872.8041
New York

Eliot D. Raffkind
eraffkind@akingump.com
214.969.4667
Dallas

Stephen M. Vine
svine@akingump.com
212.872.1030
New York