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FTC Releases Expansive Interpretation of “Red Flags” Rule for a Wide Range of Industries

The Federal Trade Commission (FTC) recently issued “Fighting Fraud with the Red Flags Rule: A How-To Guide for Business” (Guidance) elaborating on the Identity Theft Red Flags Rule (Red Flags Rule)¹ published by the FTC pursuant to the federal Fair Credit Reporting Act. The Guidance is intended to provide assistance to the private sector regarding not only the scope of application of the Rule, but also how companies may approach their compliance with the Red Flags Rule. Although the Guidance contains information regarding compliance strategies, much of this information was already available in prior releases from the FTC and other regulatory agencies. More notable, however, is that the Guidance conveys the FTC’s interpretation that the Red Flags Rule applies to a wider variety of industry sectors and “accounts” than was apparent on the face of the Rule. Among other things, the FTC notes that the Red Flags Rule may apply to a wide variety of consumer and business relationships involving health care providers, utilities, telecommunications companies, mutual funds, broker-dealers, merchants that accept credit applications, auto dealers, real estate agents and mortgage brokers. The FTC has stated previously that it may begin enforcing the Red Flags Rule as early as May 1, 2009, so all retail organizations and other businesses should re-evaluate their compliance posture in light of this new guidance.

General Requirements of Red Flags Rule

The Red Flags Rule requires any “financial institution” or “creditor” that offers or maintains “covered accounts” to develop and implement a written Identity Theft Prevention Program (Program) that is designed to detect, prevent and mitigate identity theft in connection with the opening of a “covered account,” or in connection with an existing “covered account.” The Program must include reasonable policies and procedures to: (i) identify relevant identity theft risks (red flags); (ii) detect red flags; (iii) respond to red flags; and (iv) ensure the Program is updated periodically. The Red Flags Rule also describes how the Program must be administered, including by requiring approval of the initial Program by the board of directors of the covered entity or a committee thereof.

¹ See 16 C.F.R. Part 681.

Companies and Accounts Subject to the Red Flags Rule

It is critical for a company to determine whether it is a “financial institution” or a “creditor” as defined in the Red Flags Rule.² The FTC’s interpretation of the Red Flags Rule provides an extremely broad definition for these terms. According to the FTC, a “financial institution” generally includes not only depository institutions, but also any person who, directly or indirectly, holds a “transaction account,” which it considers to be any account with check-writing privileges or that supports payments or transfers to third parties. As discussed below, this could include an investment company or a broker-dealer that offers check access to mutual funds or brokerage assets.

A “creditor” is a person who regularly defers payment for goods or services and bills customers in arrears. According to the FTC, a creditor is also one who regularly grants loans, arranges for loans or the extension of credit, makes credit decisions or regularly participates in the decision to extend, renew or continue credit. Thus, notwithstanding the face of the Red Flags Rule, which appears to apply only to institutions that actually hold “accounts,” the FTC indicates that even mortgage brokers or debt collectors that renegotiate credit terms may be subject to the Red Flags Rule. Furthermore, the term is not limited to consumer creditors—it also applies to companies that extend credit to, arrange credit for, or make credit decisions involving other businesses, although many types of business credit presumably do not raise significant identity theft risks. The FTC notes that utility companies, health care providers, retailers who process credit card applications and telecommunications companies all could be “creditors” under the Red Flags Rule.

If a company is either a “financial institution” or a “creditor” under the Red Flags Rule, it must determine whether it offers or maintains any “covered accounts.” An “account” is a continuing relationship established by a person with a financial institution or creditor to obtain a product or service.³ An

² See 16 C.F.R. § 681.2(b)(5) and (b)(7).

³ See 16 C.F.R. § 681.2(b)(1).

account can be for consumer or business purposes. A “covered account” is an account: (i) offered for consumer purposes that involves or is designed to permit multiple payments or transactions; or (ii) for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft.⁴ In other words, many consumer accounts will be covered automatically, while a financial institution or creditor must determine whether other types of accounts, such as commercial or business accounts, pose a reasonably foreseeable risk of identity theft.

The Guidance indicates that the FTC takes a very expansive view of what could be a covered account. For example, the Guidance indicates that once an entity is considered a “creditor,” it must determine whether a wide variety of other “accounts” constitute “covered accounts” subject to the Red Flags Rule, even if such accounts do not involve the extension of credit or a transaction account. In other words, a creditor would have to review all its “continuing relationships” with customers for purposes of determining whether they are actually covered accounts. The same is true for a financial institution—it must review all of its accounts, not just transaction accounts, to determine whether they may be covered accounts. Moreover, the FTC even suggests that, notwithstanding that the definition of “account” requires a “continuing relationship,” single transaction consumer “accounts” may be covered.

Application to Health Care

Health care providers routinely bill patients and others in arrears, and therefore could meet the definition of “creditor” under the Red Flags Rule. Under the FTC’s interpretation, such providers should review the types of relationships they have with all parties—not just those to whom they extend credit—to determine whether such relationships are also “covered accounts.” For example, if a hospital or a doctor is a “creditor” because it regularly bills patients in arrears, any relationship with any individual patient for which the hospital or doctor envisions multiple payments or transactions could be

⁴ See 16 C.F.R. § 681.2(b)(3).

a covered account subject to the Red Flags Rule—regardless of whether credit is extended. This could create significant compliance issues not only for smaller health care providers, but also for larger health care providers such as hospitals that may have a variety of relationships that could be “covered accounts” subject to the Red Flags Rule.

Application to Retail Industry

The Guidance indicates that the FTC views “retailers that offer financing or help consumers get financing from others, say, by processing credit applications” as *creditors*. The Guidance does not indicate whether, or how, such retailers would have an “account” if the credit is actually provided by a third party, but FTC staff has reportedly indicated informally—not in the Guidance—that such retailers must adopt a Program in connection with their efforts to offer third party point-of-sale financing or to process credit card applications. Adoption of a Program by a retailer would require approval by the retailer’s board of directors or a committee thereof (or senior management if the retailer has no board of directors). Moreover, once the retailer is considered a “creditor,” the FTC appears to be taking the position that the retailer must consider whether it has any other “account” relationships that pose a reasonably foreseeable risk of identity theft.

Application to Telecommunication Companies and Utilities

The Guidance includes an example of how the FTC would apply the Red Flags Rule to a telecommunications company. It states that “a telecommunications company that has accounts that are billed after service is rendered (credit accounts) and accounts that are prepaid or paid when service is rendered (non-credit accounts) would have to evaluate both types of accounts to determine if they are covered” accounts. Thus, while a wireless carrier that provides solely prepaid services does not appear to be covered by the Red Flags Rule, if the same carrier also provides credit accounts, it would need to

consider whether its prepaid services creates a reasonably foreseeable risk of identity theft. If so, such prepaid wireless accounts would be treated as covered accounts under the Red Flags Rule. This example may be equally applicable to utility companies.

Application to Broker-Dealers and Mutual Funds

The Guidance indicates that broker-dealers and mutual funds that offer accounts with check-writing privileges are “financial institutions” under the Red Flags Rule. The Guidance also states that a “broker-dealer that offers accounts with check-writing privileges (transaction accounts) and without those privileges (non-transaction accounts) would have to consider both kinds of accounts to determine if” the accounts are covered accounts. It would appear that the same could be said for a mutual fund. It is also important to note that a broker-dealer or mutual fund may also be a “financial institution” if it offers accounts where the account holder can make payments or transfers of funds to third parties without the use of checks.

In light of the extraordinary breadth of the Guidance, companies that previously concluded they were outside the scope of coverage of the Red Flags Rule should re-assess those conclusions. Similarly, companies that are subject to the Red Flags Rule need to reconsider the scope of their compliance programs. Such reconsideration should take place quickly in light of the FTC’s stated enforcement date of May 1, 2009.

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