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COMPLIANCE WATCH: Identity Theft Rules Coming for Industry

By Suzanne Barlyn

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NEW YORK (Dow Jones)--Broker-dealers who are confused about whether new Federal Trade Commission identity theft regulations apply to their businesses will likely be required to beef up fraud prevention programs anyway. The Securities and Exchange Commission will adopt its own proposal that would impose similar mandates, according to an SEC attorney.

The FTC regulations - known as Identity Theft Red Flags Rules - become effective on Nov. 1. The FTC and federal banking agencies issued the rules under the Fair and Accurate Credit Transactions, or FACT, Act of 2003, which require that financial institutions and creditors with certain "covered accounts" adopt policies and procedures to implement the agencies' identity theft guidelines.

Meanwhile, the SEC will adopt proposed amendments to Regulation S-P, the agency's privacy rules promulgated in 2000 under Section 504 of the Gramm-Leach-Bliley Act, said SEC attorney Jennifer McHugh during a panel presentation at the National Society of **Compliance** Professionals annual meeting in Philadelphia on Tuesday.

The SEC's Regulation S-P proposed amendments would require broker-dealers, investment advisors and other companies to implement more specific policies for protecting and disposing of confidential client information. They would also require regulated businesses to develop policies for reacting to data breaches, such as notifying customers if misuse of their information is likely.

McHugh was hesitant to comment on precisely when the agency may adopt the amendments but told the audience that adoption by year's end was possible.

The SEC's proposed amendments, announced in March, received more than 400 comments - a significant number for a **compliance**-related issue, said McHugh. Responses were generally supportive of protecting client information. However, some concerns include potential costs, client notification responsibilities and questions about transferring client information to subsequent firms when a registered representative changes employers.

McHugh told those attending that harmonization between the Regulation S-P amendments and the FTC Red Flags Rules, where possible, would be preferable.

Many broker-dealers have been confused about whether the FTC rules apply to their businesses, says Scott J. Carpenter, an attorney with Proskauer Rose LLP in Washington, D.C. "The FTC is not an agency that typically has regulatory power or jurisdiction over broker-dealers," he says.

The Securities Industry and Financial Markets Association, or SIFMA, a Washington, D.C.-based

trade organization, advised its membership in September to review the rules and "if appropriate, seek advice of their counsel as to whether the rules are applicable to their firm," according to a memorandum obtained by Dow Jones Newswires.

Former Federal Reserve attorney Gilbert T. Schwartz, now a partner at Schwartz & Ballen LLP in Washington D.C., drafted an accompanying memo to the SIFMA communique. He wrote that an announcement of the Red Flags Rules in the Federal Register indicates that the definition of "account" applies to brokerage activities. The rules also expressly cite "margin account" as an example of a covered account, according to Schwartz' memo. The agencies "would likely consider a broker-dealer to be a creditor for purposes of the Red Flags Rules if it maintains margin accounts for customers primarily for personal, family or household purposes," wrote Schwartz.

Some broker-dealers aren't taking chances. Jim Adleman, general counsel for Commonwealth Financial Network in Waltham, Mass., says the independent broker-dealer is assuming the FTC rules apply, based on its own analysis and consultations with its outside counsel, as well as industry peers.

The FTC regulations and proposed Regulation S-P amendments both aim to encourage the development of detailed programs that safeguard client information and promote identity theft prevention. However, the FTC regulations go slightly further by requiring companies to develop programs that specifically identify and detect "red flags" - or warning signs - of identity theft, he says. Those signs may include unusual account activity or fraud alerts on a consumer report. FTC-mandated programs must describe responses that would prevent and mitigate such crimes.

Many businesses won't meet the November 1 deadline, according to Sai Huda, chairman and chief executive officer of **Compliance Coach**, a Washington, D.C., **compliance** software company.

"The majority of entities are either not aware, or putting it off until the last minute because they're underestimating the challenge," he says. It's highly unlikely that businesses which are first examining the regulations will be able to comply by Nov. 1, says Huda. An appropriate **compliance** program under the regulations requires staff training and board approval, he says.

Non-compliant businesses - such as banks, health-care organizations and automobile dealerships that offer financing - risk heightened liability to customers in the event an identity theft occurs. "It's not a technical requirement. It's an affirmative obligation to take proactive steps," says Huda.

Costs of complying with FTC's regulations will vary, based on factors such as the size of a business and number of covered accounts, says Huda of **Compliance Coach**. Costs could run between \$10,000 to \$100,000 for a small to mid-sized business, he says.

(Suzanne Barlyn writes **Compliance Watch**, a column that focuses on **compliance** and regulatory issues affecting financial advisors. She can be reached at 201-938-4546 or by email at suzanne.barlyn@dowjones.com)

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