Red Flags Rule: A Guide for Agencies

Courts and vendors keep the spotlight on compliance issues.

The Federal Trade Commission (FTC) announced last year the delay of enforcement until June 1, 2010 of the Red Flags Rule (Rule). The Rule was designed to fight identity theft by requiring creditors with certain kinds of accounts to implement compliance programs to detect and prevent identity theft.

The Rule has remained in the news since the new enforcement date was announced because of two noteworthy court challenges to positions taken by the FTC about application of the Rule to some professionals, and due to a few vendors' aggressive efforts to generate business for themselves by tactics that have caused confusion.

The FTC lost a high profile lawsuit filed against it last August by the American Bar Association (ABA), which challenged the FTC's expansive definition of "creditors" under the Rule as including lawyers. A federal judge for the U.S. District Court for the District of Columbia decided on October 29, 2009 in that case that the Rule does not apply to lawyers, giving law firms a reprieve from creating compliance programs required of creditors subject to the Rule. The court stated that the Fair and Accurate Credit Transaction Act of 2003 – which is the legislation that authorized the FTC to draft the Rule – was not "created as a means of eliminating all types of identity theft, but rather to eliminate a specific kind of identity theft: identity theft in the credit industry." The judge concluded that the FTC "not only seeks to extend its regulatory power beyond that authorized by Congress, but it also untimely and arbitrarily selects monthly invoice billing as the activity it seeks to regulate." The court also noted that "state-level authorities have throughout the history of our nation regulated the conduct of attorneys, not the federal government." The judge went on to say that "Congress does not tend to interject itself into an arena where it hasn't generally ventured without explicit explanation hoping that the states will not notice the usurpation of their authority."

The second lawsuit about the Rule getting national attention was filed against the FTC by the American Institute of Certified Public Accountants (AICPA) on November 10, 2009. It was filed in the same court as the ABA lawsuit and included arguments very similar to those made by the ABA. There has been no decision yet in that lawsuit.

In light of the questions generated by the expansive approach the FTC has taken to the application of the Rule, and despite the court's strongly worded opinion opposing the FTC interpretation, some vendors have attempted to take advantage of the uncertainty in this area. They have done so by making broad-based conclusions about the application of the Rule to all businesses in certain professions, thereby instilling fear in an effort to sell their services and enhance their profits. Some vendors have even stated that all insurance agencies must comply with the Rule, which is not accurate. Despite short-hand references to specific professions commonly used in media reports about the Rule, the Rule does not regulate businesses merely by virtue of them having certain kinds of professionals, like lawyers, accountants or insurance agents/brokers; it regulates specific activities involving credit that may or may not arise with those or any other professionals or businesses.

In short, the Rule requires "financial institutions" and "creditors" that hold "covered accounts" to implement a written program ("Program") to detect warning signs or "red flags" of identity theft, so that identity theft can be prevented and mitigated.

Some key definitions under the Rule, in general terms, include:

• financial institutions - state/national banks, state/federal savings and loan associations, mutual savings banks, state/federal credit unions, or any other entity with an account from which the owner makes payments/transfers

• creditor – a person, business or entity that provides goods or services in advance of receiving payment (e.g., arranges, extends or renews credit)

• credit - the right granted by a creditor to a debtor to defer payment of a debt or to purchase property/services and defer payment for them

• covered account – an account used for a personal, family or household purpose involving multiple payments (e.g., credit card accounts, checking accounts, car/home loans)

An insurance agency only needs to comply with the Rule if it acts as a creditor or financial institution and has covered accounts, but it does not need to comply with the Rule merely because of its status as an insurance agency. For example, if all business of an insurance agency is direct billed by carriers, then the agency would not be a creditor or have covered accounts, and thus it would not be subject to the Rule. On the other hand, if the agency provides or arranges premium financing for insureds, then it appears that the FTC will take the position that the agency is acting as a creditor with covered accounts, and needs to comply with the Rule.

The acceptance of credit card payments by an insurance agency does not alone make it a creditor under the Rule, nor does merely passing along an advertising brochure to a customer for it to seek third party financing. But, a business that "regularly arranges for the extension, renewal or continuation of credit," such as is the case with mortgage brokers and auto dealers, will be considered to meet the Rule's definition of a creditor. And if a creditor, be it an insurance agency or any other business, has covered accounts, then that business must comply with the Rule. In other words, it is not the line of work a business is in that controls whether or not it is subject to the Rule; rather, it is the activities of the business that determine if it is subject to the Rule.

Insurance agencies with questions about if the Rule applies to their specific business activities can seek guidance from local counsel. In addition, some agencies in this position, out of an abundance of caution, may choose to comply with the Rule, rather than spend time or money seeking a definitive answer to a question that may be unduly complex by virtue of the way the Rule is written. For insurance agencies that decide to adopt an identity theft program even if not required to do so, the Program requirements under the Rule may be a good starting point for deciding what to include in the Program.

A Program must enable the business covered by the Rule to:

1. identify red flags (described below) relevant to the entity's experience, industry, and likely risks;
2. detect the red flags identified;
3. respond appropriately to red flags that are detected in an effort to prevent and mitigate identity theft; and
4. update the Program periodically to reflect changes in risk.

Red flags or warning signs of identity theft may come from things such as past incidents of identity theft, reports in industry publications, and information published by regulators like the FTC. Examples of red flags can include things such as warnings/alerts from credit bureaus, presentation of suspicious documents (such as those with suspicious personal identifying information or a suspicious address change), and notice from a person who believes he/she has been a victim of identity theft.

An entity required to have a Program must have the initial Program approved by its board of directors or an appropriate committee of its board of directors. In addition, the board of directors, an appropriate committee of the board, or someone from senior management must be involved in the oversight, development, implementation, and administration of the Program, and the entity's staff must be trained to implement the Program.

For insurance agencies that want help with the development of a Program, local counsel or vendors can provide a valuable service. However, it is important to work with professionals knowledgeable about the issue. Just as an insurance agency would not have its compliance Program developed by a divorce lawyer, the agency also should not choose a vendor that is not well-informed about the Rule. Vendors claiming that the Rule applies across the board to all insurance agencies merely by virtue of

them being insurance agencies are, at best, misinformed, and thus not well-positioned to provide the expertise and assistance being sought.

IIABA will continue to monitor any appeals, responses or other developments about the ABA and AICPA cases, as well as any other lawsuits/regulatory actions that may be filed about the application of the Rule, and report on anything that may affect its application to independent insurance agencies.

The Big "I" summary of the Rule is in a memo titled, "Overview of the Fair Credit Reporting Act, the Fair and Accurate Credit Transactions Act, and the Drivers Privacy Protection Act," starting on page 10 at letter G. This memo is available to Big "I" members who log in to ***www.independentagent.com*** and select Legal Advocacy, under Memoranda and FAQs. Additional information on the Rule is available from the FTC at ***http://www.ftc.gov/bcp/edu/pubs/business/alerts/alt050.shtm***.

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