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## FEDERAL TRADE COMMISSION'S "RED FLAGS RULE" FOR TELECOMMUNICATIONS CARRIERS

EFFECTIVE JUNE 1, 2010

On June 1, 2010, the Federal Trade Commission's ("FTC's") "Red Flags Rule" ("Rule") will go into effect. This Rule applies to many businesses and organizations, including most telecommunications companies. It requires the implementation of a written Identity Theft Prevention Program ("Program") structured to detect the indicia - or "red flags" - of identity theft in daily operations. The following explains which telecommunications providers are affected by these Rules and outlines general steps for compliance.

Businesses and organizations subject to the Rule are responsible for implementing a written Program designed to detect, prevent, and mitigate identity theft.<sup>1</sup> "By identifying red flags in advance," the FTC has reasoned a business will be "better equipped to spot suspicious patterns when they arise and take steps to prevent a red flag from escalating into a costly episode of identity theft."<sup>2</sup>

### *Companies that Must Comply with the Rule*

While the FTC is normally barred from regulating common carriers subject to the Communications Act of 1934, as amended, regarding unfair or deceptive acts or practices,<sup>3</sup> the Red Flags Rule applies to "creditors" that maintain "covered accounts," which explicitly includes telecommunications providers.<sup>4</sup>

- "*Creditor*" is defined as "any person who regularly extends, renews, or continues credit."<sup>5</sup> The definition includes "lenders such as banks, finance companies, automobile dealers, mortgage brokers, utility companies, and telecommunications companies."<sup>6</sup>
- "*Credit*" is defined as "the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer payment therefor."<sup>7</sup>

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<sup>1</sup> 15 C.F.R. § 681.2(d)(1).

<sup>2</sup> Federal Trade Commission: Are you complying with the Red Flags Rule? (2009), <http://www.ftc.gov/redflagsrule>.

<sup>3</sup> The FTC is prohibited from directing "common carriers subject to the Acts to regulate commerce . . . from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce." 15 U.S.C. § 45(a)(2). This exemption defines 'Acts to regulate commerce' to include "the Communications Act of 1934 [47 U.S.C. 151 et seq.] and all Acts amendatory thereof and supplementary thereto" 15 U.S.C. § 44.

<sup>4</sup> 16 C.F.R. § 681.2(d)(1).

<sup>5</sup> 16 C.F.R. § 681.2(b)(5); 15 U.S.C. § 1681a(r)(5); 15 U.S.C. 1691a(e).

<sup>6</sup> 16 C.F.R. § 681.2(b)(5) (emphasis added).

- “Covered Account” is defined as an account offered or maintained by a creditor for “personal, family, or household purposes . . . such as a credit card account, mortgage loan, automobile loan, margin account, *cell phone account*, *utility account*, checking account, or savings account.”<sup>8</sup> It may also be defined as any other account offered or maintained by the creditor which bears a “reasonably foreseeable risk” of identity theft.<sup>9</sup>

Under these definitions, the Rule readily “applies to businesses that regularly defer payment until after services have been performed.”<sup>10</sup> Any telecommunications businesses that send a bill to their customers after providing service on an upfront basis, should be concerned with Rule compliance. As the FTC has observed, “[t]hieves may buy a car, obtain a credit card, or establish telephone or Internet service using someone else’s identity. . . . Telecommunications companies may be the first to spot the red flags that signal the risk of identity theft, including suspicious activity suggesting that crooks may be using stolen information to establish service.”<sup>11</sup>

Small telecommunications businesses may be able to take advantage of a pending Congressional exemption to the Rule. H.R. 3763, a bill “to amend the Fair Credit Reporting Act to provide for an exclusion from Red Flag Guidelines for certain businesses,” was passed by the House of Representatives on October 20, 2009. The next day, it was referred to the Senate Committee on Banking, Housing, and Urban Affairs for further action. Should the bill become law, the term “creditor,” for purposes of the Rule, would no longer include any business that “(i) knows all of its customers or clients individually; (ii) only performs services in or around the residences of its customers; or (iii) has not experienced incidents of identity theft and identity theft is rare for businesses of that type.”<sup>12</sup>

### ***How does a Business Comply with the Red Flags Rule?***

Compliance with the Red Flags Rule is *risk-based*, according to the possible forms of identity theft that a business is likely to encounter. In the words of FTC Chairman Jon Leibowitz, the Red Flags Rule “requires *reasonable* policies and procedures to identify, detect, prevent, and mitigate identity theft and has a flexible, risk-based structure to allow entities to design a Program that is tailored to the nature of their business.”<sup>13</sup> This means that a business takes into account its size and complexity, as well as the

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<sup>7</sup> 16 C.F.R. § 681.2(b)(4); 15 U.S.C. 1681a(r)(5); 15 U.S.C. 1691a(d).

<sup>8</sup> 16 C.F.R. § 681.2(b)(3)(i) (emphasis added).

<sup>9</sup> 16 C.F.R. § 681.2(b)(3)(ii).

<sup>10</sup> Federal Trade Commission, *The Red Flags Rule: Frequently Asked Questions* (2009), <http://www.ftc.gov/bcp/edu/microsites/redflagsrule/faqs.shtm> (“FTC Rule FAQ”).

<sup>11</sup> Tiffany George and Pavneet Singh, Federal Trade Commission, *The “Red Flags” Rule: What Telecom Companies Need to Know About Complying with New Requirements for Fighting Identity Theft*, Missouri Telecommunications Industry Association Trade Review (Jan. 2009), [http://mtia.org/trade/2009\\_january.html](http://mtia.org/trade/2009_january.html).

<sup>12</sup> H.R. 3763, 110th Cong. (2009). The bill also exempts “(A) a health care practice with 20 or fewer employees; (B) an accounting practice with 20 or fewer employees; (C) a legal practice with 20 or fewer employees” from the definition of “creditor.”

<sup>13</sup> Letter from Jon Leibowitz, Chairman, Federal Trade Commission, to The Honorable Nydia M. Velázquez,

nature of its operations, when designing a Rule-compliant Program.<sup>14</sup> It also means that no “one-size-fits-all” Program can readily be adopted, as every business faces unique risks.

Once a business determines that it is a creditor *with* covered accounts for purposes of the Rule, it “must develop and implement a written Program to detect and respond to the red flags of identity theft” and “update it periodically.”<sup>15</sup> If a business determines that it is a creditor *without* covered accounts, it need not implement “a written Program,” but must “still . . . conduct periodic risk assessments to determine if [it has] acquired any covered accounts through changes to [its] business.”<sup>16</sup>

In designing a Program, a business should be conversant with its covered accounts - from the type of accounts it offers to customers to the ways in which they can be opened and accessed. A business should also consider the ways in which red flags may appear in those accounts, including its actual experience with identity theft, known or suspected weaknesses, and supervisory guidance.<sup>17</sup> The FTC recommends that a business design its Program according to the red flags it is likely to encounter in day-to-day operations. Some general categories of red flags to consider are:

- alerts, notifications, or warnings from a consumer reporting agency;
- suspicious documents;
- suspicious personally identifying information, such as a suspicious address;
- unusual use of – or suspicious activity relating to – a covered account; and
- notices from customers, victims of identity theft, law enforcement authorities, or other businesses about possible identity theft in connection with covered accounts.<sup>18</sup>

The identity theft Program “must include reasonable policies and procedures” that accomplish the following tasks:

- *Identify* red flags relevant to the business.
- *Incorporate* those red flags them into the Program;

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Chairwoman, Committee on Small Business, U.S. House of Representatives, at 7 (May 26, 2009), *available at* <http://www.ftc.gov/os/closings/staff/090526nydiavelazquezletter.pdf> (emphasis in original).

<sup>14</sup> See Federal Trade Commission, FTC Business Alert: New ‘Red Flag’ Requirements for Financial Institutions and Creditors Will Help Fight Identity Theft (June 2008), <http://www.ftc.gov/bcp/edu/pubs/business/alerts/alt050.shtm> (“FTC Business Alert”).

<sup>15</sup> FTC Rule FAQ, *supra* n. 19.

<sup>16</sup> *Id.*

<sup>17</sup> See 16 C.F.R. § 681, Appendix A.

<sup>18</sup> FTC Business Alert, *supra* n. 22.

- *Detect* those red flags if and when they appear;
- *Respond* to red flags in order to prevent and mitigate identity theft; and
- *Update* incorporated red flags in order to reflect changing risks to customers and to the business itself.<sup>19</sup>

In addition, a business “must provide for the continued administration of the Program” by discharging the following responsibilities:<sup>20</sup>

- Obtaining approval for the Program from its board of directors or a committee thereof;
- Develop, implement, administer, and oversee the Program through the involvement of a member of senior management, the board of directors, or a committee thereof;
- Train staff to implement the Program; and
- Effectively oversee service provider arrangements made pursuant to the Program.<sup>21</sup>

The Rule also instructs businesses to consult the guidelines found in 16 C.F.R. § 681, Appendix A, “and include in its Program those guidelines that are appropriate.”<sup>22</sup> The Appendix provides further guidance for how to detect, mitigate, and prevent identify theft and update and administer the Program.

### ***History of the Red Flags Rule Adoption***

The Red Flags Rule was enacted by the Fair and Accurate Credit Transactions Act of 2003 (“FACT Act”), which required federal financial regulatory agencies and the FTC to “establish and maintain guidelines for use by each financial institution and each creditor regarding identity theft.”<sup>23</sup> On November 9, 2007, the FTC, Federal Deposit Insurance Corporation (“FDIC”), Federal Reserve Board (“FRB”), Office of the Comptroller of the Currency (“OCC”), Office of Thrift Supervision (“OTS”), and the National Credit Union Administration (“NCUA”) finalized the Red Flags Rule through a joint notice of final rulemaking.<sup>24</sup> One year later, on November 1, 2008, the Rule became effective for businesses under the auspices of the FDIC, FRB, OCC, OTS, and NCUA.<sup>25</sup>

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<sup>19</sup> See 16 C.F.R. § 681.2(d)(2)(i) - (iv).

<sup>20</sup> 16 C.F.R. § 681.2(e).

<sup>21</sup> See 16 C.F.R. § 681.2(e)(1) - (4).

<sup>22</sup> 16 C.F.R. § 681.2(f).

<sup>23</sup> Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, § 114, 117 Stat 1952, 1960-61 (2003).

<sup>24</sup> See Identity Theft Red Flags and Address Discrepancies Under the Fair and Accurate Credit Transactions Act of 2003; Final Rule, 72 Fed. Reg. 63718 (Nov. 9, 2007).

<sup>25</sup> Federal Trade Commission, FTC Extended Enforcement Policy: Identity Theft Red Flags Rule, 16 CFR 681.1 (July

Entities subject to the Red Flags Rule, but outside the jurisdiction of the federal regulatory agencies, were initially required to comply with the Rule by November 1, 2008. However, as the FTC began its education and outreach efforts following publication of the rule, it discovered that some industries and entities within the FTC’s jurisdiction were confused and uncertain about the rule.<sup>26</sup> Some businesses “noted that because they generally are not required to comply with FTC rules in other contexts, they had not followed or even been aware of the rulemaking, and therefore learned of the requirements of the rule too late to be able to come into compliance by November 1, 2008.”<sup>27</sup> Citing “confusion and uncertainty within major industries,” the FTC postponed enforcement until May 1, 2009,<sup>28</sup> and then again until August 1, 2009.<sup>29</sup> On July 29, 2009, the FTC announced that it would once more delay enforcement until November 1, 2009, intending to “redouble its efforts to educate [businesses] about compliance with the ‘Red Flags’ Rule and ease compliance by providing additional resources and guidance to clarify whether businesses are covered by the Rule and what they must do to comply.”<sup>30</sup>

On August 27, 2009, the American Bar Association (“ABA”) filed a three-count complaint in the District Court for the District of Columbia, claiming that the FTC’s extension of the Rule “to attorneys exceeds the Commission’s statutory authority” under the FACT Act.<sup>31</sup> The Court granted summary judgment on the first count of the complaint, which alleged that the FTC’s application of the Rule was arbitrary and capricious. The Court took “note that no statement indicating that the Rule would be applicable to the legal profession accompanied either the Proposed Red Flags Rule or its final version, or was included in the comments accompanying the rulemaking.”<sup>32</sup> As “the FACT Act was created to apply to entities involved in banking, lending, or financial related business” and designed “to eliminate a specific kind of identity theft: identity theft in the credit industry,” the statute’s “context is inconsistent with the regulation of attorneys.”<sup>33</sup> Given that the FTC’s extension of the Rule to lawyers “creates another barrier for attorneys to build the level of trust necessary for clients to feel that they can openly

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29, 2009), <http://www.ftc.gov/os/2009/07/P095406redflagspolicy.pdf>.

<sup>26</sup> Federal Trade Commission, FTC Enforcement Policy: Identity Theft Red Flags Rule, 16 CFR 681.2 (Oct. 22, 2008), <http://www.ftc.gov/os/2008/10/081022idtheftredflagsrule.pdf> (“FTC Extended Enforcement Policy”).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> FTC Extended Enforcement Policy, *supra* n. 3.

<sup>30</sup> Federal Trade Commission, FTC Announces Expanded Business Education Campaign on 'Red Flags' Rule (June 29, 2009), <http://www.ftc.gov/opa/2009/07/redflag.shtm>.

<sup>31</sup> *American Bar Ass’n v. F.T.C.*, 671 F.Supp.2d 64, 66 (D.D.C. 2009).

<sup>32</sup> *Id.* at 68.

<sup>33</sup> *Id.* at 74; *see id.* at 75 (“Credit applications, appraisal reports, account holders and customers are all concepts foreign to the practice of law, not squarely falling within the universe of terms used to describe participants in the legal profession or the types of activities conducted by attorneys, nor the types of relationships attorneys have with their clients”).

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communicate with their attorneys,” the Court concluded that it was “both plainly erroneous and inconsistent with the purpose underlying the enactment of the FACT Act.”<sup>34</sup>

On October 30, 2009, “[a]t the request of Members of Congress,” the FTC once more “delay[ed] enforcement of the ‘Red Flags’ Rule until June 1, 2010, for financial institutions and creditors subject to enforcement by the FTC.”<sup>35</sup> Nearly two months later, the FTC and ABA issued a joint statement, agreeing that no further Court action was needed on the second and third counts of the ABA’s complaint - attorneys were clearly outside the scope of the Rule.<sup>36</sup> Nonetheless, the FTC appealed its loss in late February 2010.<sup>37</sup>

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Chérie R. Kiser, 202.862.8950, ckiser@cahill.com.

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<sup>34</sup> *Id.* at 87-88.

<sup>35</sup> Federal Trade Commission, FTC Extends Enforcement Deadline for Identity Theft Red Flags Rule (Oct. 30, 2009), <http://www.ftc.gov/opa/2009/10/redflags.shtm>.

<sup>36</sup> *See American Bar Ass’n v. F.T.C.*, Civil Action No. 09-1636 (RBW) (Joint Statement Regarding Further Action in this Matter filed Dec. 22, 2009).

<sup>37</sup> American Bar Association, *Statement of ABA President Lamm Re: FTC Appeal of Loss in Red Flags Litigation* (Feb. 26, 2010), <http://www.abanow.org/2010/02/statement-of-aba-president-lamm-re-ftc-appeal-of-loss-in-red-flags-litigation/>; Kimberly Atkins, Lawyers USA, *FTC appeals U.S. District Court's 'red flags' ruling* (Feb. 28, 2010), available at <http://www.allbusiness.com/legal/trial-procedure-decisions-rulings/14061005-1.html>.

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