GROOM LAW GROUP

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RED FLAGS RULE: APPLICATION TO HEALTH FLEXIBLE SPENDING ACCOUNTS, HEALTH REIMBURSEMENT ARRANGEMENTS, DEPENDENT CARE ASSISTANCE PROGRAMS AND TRANSPORTATION PLANS

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Effective November 1, 2009, the Federal Trade Commission ("FTC") is set to begin enforcement of the Red Flags Rule. As discussed further below, the Red Flags Rule likely applies to employers, third party administrators and/or debit card issuers with respect to account-based health and welfare plans that offer a debit card.

Overview of the Red Flags Rule Identity Theft Prevention Program

Under the Red Flags Rule, certain businesses and organizations (collectively hereinafter "entity") must establish and implement a written Identity Theft Prevention Program ("ITPP"). To comply with the Red Flags Rules, a written ITPP must have four basic elements:

(1) The ITPP must establish reasonable policies and procedures to **identify** the "red flags" of identity theft that the entity may come across during the entity's day-to-day operations. Red flags are specific activities, patterns, or practices that indicate the possibility of identity theft. For example, the entity may identify the use of a fake ID by a customer as a red flag

(2) The ITPP must be designed to **detect** the red flags that the entity has identified. For example, the entity may have a procedure in place to detect possible fake IDs.

(3) The ITPP must state the **actions** that will be taken when red flags are detected. For example, the entity may have a procedure for reporting potential fake IDs to a manager or a specialist in before proceeding with a customer.

(4) The entity must reevaluate the ITPP periodically for new risks of identity theft.

An entity's Board of Directors (or a Committee of the Board), or if no board exists an appropriate senior-level employee, must approve the ITPP and must be involved in the ITPP's oversight, development, implementation, and administration. The ITPP must indicate the party responsible for implementing and administering the ITPP. The entity must train appropriately its staff on how to implement the ITPP. An entity that uses a service provider must ensure that the service provider either complies with the entity's ITPP or has policies and procedures in place to comply independently with the Red Flags Rule.

The FTC has issued a form that provides guidance for implementing an ITPP. <u>See</u> http://www.ftc.gov/bcp/edu/microsites/redflagsrule/get-started.shtm. The guidance is directed at low-risk entities, but provides a basic starting point for any entity implementing an ITPP.

Who Must Comply with the Red Flags Rule?

The Red Flags Rule applies to "financial institutions" and "creditors." A "financial institution" is any bank, credit union, or savings and loan association, or "any other person that, directly or indirectly, holds a transaction account belonging to a consumer." A "transaction account" is a deposit or account from which a consumer can make payments or transfers to third parties.

A "creditor" is an entity that regularly provides goods or services first and later accepts payment for them, such as a utility company. A "creditor" is also any entity that regularly grants loans, arranges for loans, extends credit, or makes credit decisions, such as a mortgage broker.

All financial institutions and creditors are subject to the Red Flags Rule. They must periodically assess whether they have "covered accounts." If a financial institution or creditor has a covered account, the entity must establish and implement a written ITPP.

An "account" is "a continuing relationship established by a person with a financial institution or creditor to obtain a product or service for personal, family, household, or business purposes." An account constitutes a "covered account" in one of two ways: **Method One.** If an account is offered or maintained primarily for personal, family, or household purposes that involves multiple payments or transactions, then the account is always considered a "covered account." **Method Two.** If an account does not satisfy the Method One criteria, the account may still be a "covered account" if a reasonably foreseeable risk of identity theft exists. Each financial institution and creditor must determine whether its accounts are "covered accounts" under either of these methods. With respect to Method Two, a risk evaluation should be performed, including consideration of the methods the entity opens accounts and provides access such accounts, as well as any previous experience the entity has with identity theft.

Application of Red Flags Rule to Health FSAs, HRAs, DCAPs and Transportation Plans

The FTC recently issued FAQs that addressed specifically health care flexible spending accounts ("FSAs"). The FTC expressly stated that the offering of an FSA to employees would not cause an employer or the TPA to be considered creditors under the Red Flags Rule. But, the FTC also expressly stated that an entity that offers employees an FSA with a debit card will be considered a financial institution. The FTC's recent guidance, however, is unclear as to which entity – the employer, the TPA, and/or debit card issuer – will be considered a financial institution under the Rule. Without further guidance on this issue, employers and TPAs should approach these arrangements cautiously by establishing and implementing an ITPP. TPAs that issue debit cards to employees and/or monitor third party payments should be particularly cautious, as these activities would seem to more clearly subject them to the Red Flags Rules. We believe that employers can delegate the responsibility to establish and implement an ITPP to their TPA.

The FTC guidance did not address specifically health reimbursement arrangements ("HRAs"), dependent care assistance programs ("DCAPs"), or transportation plans. But, the guidance regarding FSAs provides at least some guidance for employers and TPAs with regard to these other account-based arrangements. Based on the FTC guidance, if these arrangements do not include a debit card <u>and</u> do not in any way extend or process credit to the employee, we do not believe that employers and TPAs should be subject to the Red Flags Rule. Any time a debit card is used, however, TPAs and/or employers should establish and implement ITPPs.