

SEC Adopts Rule Governing Affiliate Marketing - Regulation S-AM

BY THE INVESTMENT MANAGEMENT PRACTICE

The Securities and Exchange Commission (the “SEC”) recently adopted Regulation S-AM (“Reg S-AM”) limiting the extent to which certain financial institutions can provide consumer information to affiliates for marketing purposes.¹ Regulation S-AM complements current restrictions contained in Regulation S-P, as we discuss below.

Whom does Reg S-AM cover?

Reg S-AM applies to brokers², dealers, investment companies, registered investment advisers, and registered transfer agents (collectively “financial institutions”). Reg S-AM governs the ability of these financial institutions to use certain information about consumers (“eligibility information”) obtained from their affiliates, or to provide such eligibility information to their affiliates, for the purpose of making marketing solicitations. A financial institution that does not have affiliates or does not communicate eligibility information to its affiliates is not subject to Reg S-AM. Reg S-AM also does not apply where eligibility information is *shared* with an affiliate but the affiliate does not *use* the information to make marketing solicitations.

In general, eligibility information is consumer information that is used or expected to be used or collected for the purpose of serving as a factor in establishing the consumer’s eligibility for (i) credit or insurance to be used primarily for personal, family, or household purposes; (ii) employment purposes; or (iii) other purposes authorized in the FCRA. Eligibility information does not include aggregate or blind data that does not contain personal identifiers such as account numbers, names, or addresses.

What are the conditions of Reg S-AM?

In general, Reg S-AM prohibits a financial institution from using “eligibility information” about a consumer received from its affiliate to make “marketing solicitations” to consumers, unless:

- the consumer has received notice of the potential marketing use of the information;
- the consumer has been provided a reasonable opportunity and a simple method to opt out of receiving the marketing solicitation; and
- the consumer did not opt out.

Hence, Reg S-AM will allow consumers in certain circumstances to control the use of their “eligibility information” for marketing purposes.³

What is a “marketing solicitation”?

Under Reg S-AM, a “marketing solicitation” means the marketing of a product or service to a particular consumer that is based on “eligibility information” communicated by a financial institution to its affiliate and is intended to encourage the consumer to purchase or obtain the affiliate’s product or service.⁴ A marketing solicitation does not include communications that are directed at the general public such as radio, television, billboard advertisements or publicly available websites that are not directed to particular consumers. It does include telemarketing calls, direct mail, e-mail, and other forms of communication directed to a particular consumer. It can also include the following depending on the circumstances: pre-recorded messages played while a consumer is on hold with a call center, advertisements that appear solely on password-protected Web sites, educational seminars, customer appreciation events, and focus group invitations.

A person is deemed to be “making” a solicitation if the person does three things: (1) receives eligibility information from an affiliate; (2) uses it to do one or more stated things as described below; and (3) as a result of that use, the consumer is provided a marketing solicitation. The stated things are: (a) identifying the consumer or type of consumer to receive a solicitation; (b) establishing criteria used to select the consumer to receive a solicitation; or (c) deciding which of the person’s products or services to market to the consumer or tailoring that person’s solicitation to that consumer.⁵

Exceptions from Marketing Solicitation — “Constructive Sharing” and Service Providers

Reg S-AM provides examples of two affiliate marketing scenarios that do not constitute marketing solicitations subject to Reg S-AM’s notice and opt-out requirements.

The first example involves “constructive sharing.” Constructive sharing occurs when a financial institution agrees to send a marketing solicitation for its affiliate’s products or services to certain of the financial institution’s customers. If the financial institution does not use “eligibility information” obtained from its affiliate in making this solicitation – if it uses instead information about the consumer obtained in connection with a pre-existing business relationship – Reg S-AM would not apply.⁶ Similarly, Reg S-AM does not apply if the financial institution directs its service provider to use the financial institution’s eligibility information to market the affiliate’s products or services and the affiliate does not communicate directly with the service provider concerning that use.

The second example involves the use of a service provider for marketing. In general, a financial institution is deemed to make a marketing solicitation under Reg S-AM if a service provider, *acting on the financial institution’s behalf*, receives or uses consumer eligibility information from the financial institution’s affiliate in connection with marketing the financial institution’s products or services. However, a financial institution does not make a marketing solicitation subject to Reg S-AM if a service provider receives eligibility information from the financial institution’s affiliate, and uses it *on behalf of the affiliate*, to market the financial institution’s services or products to the affiliate’s consumers. In this case, the following five conditions must be met in order to avoid Reg S-AM: (1) the affiliate must control access to and use of its eligibility information by the service provider by written agreement with the service provider; (2) the affiliate must establish specific written terms and conditions under which the service provider may access and use the eligibility information to market the financial institution’s products and services to the affiliate’s customers; (3) the affiliate must require the service

provider to implement reasonable policies and procedures to ensure that it uses the information in accordance with the affiliates' written terms and conditions; (4) the affiliate must be identified on or with the marketing materials provided to the consumer; and (5) the financial institution may not directly use the eligibility information to make a marketing solicitation.

The five conditions together are intended to ensure that the service provider is acting on behalf of the affiliate that obtained the eligibility information in connection with a pre-existing business relationship. In effect, this example extends the constructive sharing exception to service providers.

What are the Notice and Opt-Out Requirements?

If Reg S-AM applies, consumers must be given an initial notice that the affiliate may use eligibility information about the consumer to make marketing solicitations (the "Notice"). The Notice must be "clear, conspicuous, and concise." It must accurately disclose:

- the name of the affiliate(s) providing the Notice;
- a list of the affiliates or types of affiliates whose use of eligibility information is covered by the Notice;
- a general description of the types of eligibility information that may be used to make marketing solicitations to the consumer;
- that the consumer may elect to limit the use of eligibility information to make marketing solicitations to the consumer;
- that the consumer's election will apply for a specified period of time stated in the Notice and, if applicable, that the consumer will be allowed to renew the election once that period expires;
- if the Notice is provided to consumers who may have previously opted out, such as if a Notice is provided to consumers annually, that the consumer who has chosen to limit solicitations does not need to act again until the consumer receives a renewal notice; and
- a reasonable and simple method for the consumer to opt out.

A consumer may be given the opportunity to choose from a menu of alternatives when electing to prohibit marketing solicitations, such as by electing to prohibit solicitation from certain types of affiliates but not others or electing to prohibit certain types of marketing solicitations. However, one of the alternatives must provide the consumer with the opportunity to opt out of and prohibit all marketing solicitations from all affiliates.

Reg S-AM provides that the Notice and opt-out option can be combined with other disclosures required by law, such as the initial and annual privacy notices required by Reg S-P. It can be delivered by hand, mail, email (if approved by consumer), or posted on Website (provided consumer acknowledges receipt).

What exclusions apply?

Although there are six exclusions to the notice and opt-out requirements, the exclusion for "pre-existing business relationships" is the most useful.⁷

Reg S-AM does not apply to financial institutions that use eligibility information received from an affiliate to make a marketing solicitation to a consumer with whom the person as well as the affiliate has a preexisting business relationship." Reg S-AM defines "preexisting business relationship" as a relationship between an affiliate of a financial institution and a consumer based on (1) a financial contract between such affiliate and the consumer which is in force at the time the marketing solicitation is sent to the consumer, (2) a financial transaction (including holding an active account) between such affiliate and the consumer within 18 months preceding the date the marketing solicitation is made or sent, or (3) an inquiry or application by the consumer regarding a product or service offering by such affiliate during the three months preceding the date the marketing solicitation is made or sent.

Thus, for example, if a consumer has both an brokerage account with a broker-dealer and a banking relationship with the broker-dealer's affiliated bank, the broker-dealer may use eligibility information received by the bank to market brokerage services to the consumer without providing notice and an opportunity to opt out. Both the broker-dealer and its affiliated bank must have preexisting business relationships with the consumer for the broker-dealer's marketing solicitations to the consumer to be within this exception.

How is Reg S-AM related to Regulation S-P (the Privacy Rules)?

Regulation S-P governs a financial institution's ability to disclose or *share* nonpublic personal financial information about the financial institution's consumers to affiliates and non-affiliated third parties. Regulation S-AM does not prohibit the *sharing* of consumer information. Instead, Reg S-AM prohibits the *using* of consumer information. Reg S-P requires financial institutions to provide initial and annual privacy notices with respect to their sharing of nonpublic consumer information with affiliates and nonaffiliated third parties. The notice required by Reg S-AM may be included with the privacy notice required by Reg S-P. Reg S-AM does not affect a financial institution's ability to share information in accordance with Reg S-P.

What is the effective date of Reg S-AM?

Though compliance with Reg S-AM is currently mandatory as of January 1, 2010, the Investment Company Institute has requested a five-month extension of this compliance date to June 1, 2010 to allow sufficient time for compliance with the Regulation's notice and opt-out requirements.

If you have any questions concerning compliance with Regulation S-AM, please do not hesitate to contact any of the Paul Hastings Investment Management attorneys listed on the following page.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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- ¹ Section 624 of the Fair Credit Reporting Act ("FCRA") gives consumers the right to restrict a person from making marketing solicitations using certain information obtained about them from the person's affiliate. The Fair and Accurate Credit Transactions Act of 2003 required the SEC and other regulators to adopt rules implementing Section 624 of FCRA and impose limitations on a person's use of certain information received from an affiliate to solicit a consumer for marketing purposes. The SEC originally proposed Reg S-AM on July 8, 2004 (*Limitations on Affiliate Marketing (Regulation S-AM)*, Exchange Act Release No. 49985 (July 8, 2004)).
- ² Broker does not include a broker registered by notice with the SEC under Section 15(b) (11) of the Securities Exchange Act of 1934 (i.e. brokers subject to primary oversight by the CFTC).
- ³ Reg S-AM provides the following example: a consumer has a brokerage account with a broker-dealer. The broker-dealer furnishes eligibility information about the consumer to its affiliated investment adviser. Based on that eligibility information, the investment adviser wants to make a marketing solicitation to the consumer about its discretionary investment advisory accounts. The investment adviser does not have a pre-existing business relationship with the consumer and none of the other exceptions applies. The investment adviser is prohibited from using eligibility information received from its broker-dealer affiliate to make marketing solicitations to the consumer unless the consumer is given a notice and opportunity to opt out and the consumer does not opt out.
- ⁴ For purposes of Reg S-AM, the SEC interprets "product and services" to include shareholders investments in investment companies.
- ⁵ Reg S-AM provides the following as illustrative of a person making a marketing solicitation: a consumer has an investment advisory contract with an investment adviser that is affiliated with a broker-dealer. The broker-dealer receives eligibility information about the consumer from the investment adviser. The broker-dealer uses that information to identify the consumer to receive a marketing solicitation about its brokerage products and services and

asks the investment adviser to send the marketing solicitation to the consumer and the adviser does so. The broker-dealer has made a marketing solicitation under Reg S-AM because it used eligibility information that it received from an affiliate and as a result, a marketing solicitation was provided to the consumer.

- ⁶ For example, a broker-dealer that sells investment company shares to a consumer has a pre-existing business relationship with the consumer (as does the investment company if the consumer is the record owner of the shares). The broker-dealer may make a marketing solicitation for an investment in an affiliated investment company based on eligibility information the broker-dealer obtained in connection with its pre-existing business relationship with the consumer.
- ⁷ The exceptions are for persons that receive eligibility information from an affiliate:
- (A) to make a marketing solicitation to a consumer with whom the person has a pre-existing business relationship;
 - (B) to facilitate communications to an individual for whose benefit the person provides employee benefit or other services pursuant to a contract with an employer related to and arising out of the current employment relationship or status of the individual as a participant or beneficiary of an employee benefit plan;
 - (C) to perform services on behalf of an affiliate (subject to certain exceptions);
 - (D) in response to a communication about its product and services initiated by the consumer;
 - (E) in response to solicitations authorized or requested by the consumer; or
 - (F) if compliance would conflict with applicable provisions of state insurance laws pertaining to unfair discrimination.