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a note from Tannenbaum Helpern Syracuse & Hirschtritt LLP

California Financial Information Privacy Law to Take Effect on July 1, 2004<sup>1</sup>

To: Clients of Tannenbaum Helpern Syracuse Hirschtritt LLP

Date: March 14, 2004

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On August 27, 2003 Governor Gray Davis signed SB. 1 which enacted the California Financial Information Privacy Act (the "CFIPA").<sup>2</sup> The CFIPA's legislative intent is to impose greater obligations compared to federal standards under the Gramm-Leach Bliley Act of 1999 (the "GLBA").<sup>3</sup> A financial institution that does business in California and has consumers who are residents of California will be required to comply with the CFIPA. A financial institution that shares nonpublic personal information<sup>5</sup> of consumers who are California residents with a non-affiliated third party must obtain affirmative consent (an "opt-in") from such consumers. A financial institution that shares nonpublic personal information of consumers who are California residents with an affiliate must provide such consumers with an opportunity to opt-out before sharing the nonpublic personal information. However, the CFIPA does provide for an exception from having to provide an opt-out if the financial institution and its affiliate(s) satisfy certain conditions. Also, the CFIPA permits the sharing of nonpublic personal information without having to receive an opt-in or an opt-out from consumers if the sharing of nonpublic personal information falls within certain enumerated circumstances. Violators of the CFIPA will be subject to civil monetary penalties.

The CFIPA goes into effect on July 1, 2004.<sup>6</sup>

Ultimately, hedge fund managers should find themselves not having to provide an opt-in and/or an opt-out *provided* that the sharing of their investors' nonpublic personal information falls within the exemptions listed under Section 4056 of the CFIPA.

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<sup>1</sup> This memorandum provides general information on the subject matter described, and it should not be relied on for legal advice on any matter, which may turn on specific facts. You should seek specific legal advice before acting with regard to the subjects treated here.

<sup>2</sup> 2003 Cal. Stats., ch. 241.

<sup>3</sup> Pub. L. 106-102.

<sup>4</sup> See Section 4051(b) of the CFIPA.

<sup>5</sup> The term "nonpublic personal information" means "personally identifiable information" provided by a consumer to a financial institution." See Section 4052(a) of the CFIPA. The term "personally identifiable information" is defined to include information a consumer provides to a financial institution on an application to obtain a loan, credit card, or other financial product or service. See Section 4052(b)(1) of the CFIPA. In the context of hedge funds, personally identifiable information is the identifiable information an investor furnishes such as name, address, and social security number in the subscription documents.

<sup>6</sup> See Section 4060 of the CFIPA.

## **Who Must Comply with the CFIPA?**

Financial institutions that do business in California and collect and share nonpublic personal information must comply with the CFIPA. The CFIPA defines “financial institution” to mean “any institution the business of which is engaging in financial activities as described in Section 1843(k) of Title 12 of the United States Code<sup>7</sup> and doing business in this state.”<sup>8</sup>

Note that the term “doing business in [California]” is not defined. It is currently unclear as to what level of activity is required to be deemed to be “doing business” in California if one is an out-of-state financial institution. Until the California legislature or the California Attorney General’s office clarifies the scope of the CFIPA, it is probable that financial institutions that are located outside of California but offer financial products and/or investment advisory services to residents of California may be required to comply with the provision of the CFIPA absent an exemption.

## **The CFIPA’s Privacy Protections Apply to Who?**

The CFIPA is designed to protect “consumers” of financial institutions that do business in California. The term “consumer” is defined to mean “an individual resident of this state, or that individual’s legal representative, who obtains or has obtained from a financial institution a financial product or service to be used primarily for personal, family, or household purposes.”<sup>9</sup>

This means that if investors in a fund are natural persons who are California residents, then they are deemed to be “consumers” and are therefore entitled to the protections under the CFIPA. As such, depending upon the circumstances as described below, a fund manager would likely have to provide such investors with an opportunity to (i) opt-in before their nonpublic personal information can be shared with a non-affiliated third-party and (ii) opt-out before their nonpublic personal information can be shared with an affiliate unless their nonpublic personal information is shared in accordance with the examples described in Section 4056 of the CFIPA.

If investors in a fund are entities organized in California such as a corporation or a limited partnership, then they are not entitled to the protections under the CFIPA. Accordingly, a fund manager would not be required to provide such investors with an opportunity to opt-in and to opt-out with respect to the disclosure of nonpublic personal information.

## **Opt-In: If a Financial Institution Shares Nonpublic Personal Information with Non-Affiliated Third Parties<sup>10</sup>**

A financial institution doing business in California must first obtain an affirmative consent from its consumers before the financial institution can share nonpublic personal information with a non-affiliated third-party.<sup>11</sup> The affirmative consent must satisfy the following criteria:

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<sup>7</sup> See Section 4(k) of the Bank Holding Company Act of 1956. Financial activities include lending money, investing for others, insuring against loss, providing financial advice, or making a market in securities.

<sup>8</sup> Section 4052(c) of the CFIPA (emphasis added).

<sup>9</sup> See Section 4052(f) of the CFIPA.

<sup>10</sup> The term “non-affiliated third party” means any entity that is not an affiliate of, or related by common ownership or affiliated by corporate control with, the financial institution. See Section 4052(e) of the CFIPA.

<sup>11</sup> See Section 4053(a)(1) of the CFIPA.

- The consent must be a separate document, not attached to any other document;
- The consent must be signed and dated by the consumer;
- The consent must clearly and conspicuously disclose that by signing the consumer is consenting to the disclosure to nonaffiliated third parties of nonpublic personal information pertaining to the consumer;
- The consent must clearly and conspicuously disclose that the consent will remain in effect until revoked or modified by the consumer; that the consumer may revoke the consent at any time; and how to revoke the consent; and
- The financial institution must retain a true and correct copy of the affirmative consent and on demand supply a copy of the consent to the consumer.<sup>12</sup>

However, the opt-in requirement would not apply if sharing a consumer's nonpublic personal information falls under the situations listed under Section 4056 of the CFIPA described below.

**Opt-Out: If a Financial Institution Shares Non-Public Personal Information with an Affiliate<sup>13</sup>**

A financial institution doing business in California must first give a consumer an annual written notice as described under Section 4053(d)(1) of the CFIPA that clearly and conspicuously gives the consumer with an opportunity to opt out and such consumer has not done so before the financial institution can share the nonpublic personal information with its affiliate.<sup>14</sup> The opt-out is a detailed form, and the statute contains a model form financial institutions are to follow.<sup>15</sup>

An exception from having to provide the annual opt-out notice is available to financial institutions if the financial institution and its affiliate(s) satisfy the following conditions:

- The sharing is between a financial institution and its wholly-owned financial institution subsidiaries, financial institutions that are each wholly owned by the same financial institution or holding company;
- The same functional regulator regulates the financial institution disclosing the information and the financial institution receiving the information;
- The financial institution disclosing the information and the financial institution receiving are both principally engaged in the same line of business. The line of business must be one of the following: insurance, banking or securities; and
- The business must share a common brand within their trademark, service mark, or trade name.<sup>16</sup>

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<sup>12</sup> See Section 4053(a)(2) of the CFIPA.

<sup>13</sup> The term "affiliate" means any entity that controls, is controlled by, or is under common control with, another entity. See Section 4052(d) of the CFIPA.

<sup>14</sup> See Section 4053(b)(1) of the CFIPA.

<sup>15</sup> In addition to the obligation of having to distribute an opt-out notice, a financial institution with assets greater than \$25 million must provide a consumer with a self-addressed first-class business reply envelope with the opt-out notice. A financial institution with assets less than \$25 million must provide a consumer with a self-addressed return envelope with the opt-out notice. In lieu of the first class reply return envelope, a financial institution may provide two cost-free alternatives for consumers to opt out such as a toll-free telephone number, a toll-free fax number or an electronic return. See Section 4053(d)(6) of the CFIPA

<sup>16</sup> See Sections 4053(c)(1)-(3) of the CFIPA.

## Compliance with a Consumer's Instructions

If a financial institution receives a response to either the opt-in or the opt-out, such financial institution must comply with the consumer's request regarding the disclosure nonpublic personal information within 45 days of receipt of the request.<sup>17</sup>

### **Section 4056: Activities that Exempt a Financial Institution from Having to Provide an Opt-In or an Opt-Out**

Similar to the GLBA, the CFIPA permits the sharing of nonpublic personal information without having to obtain prior approval from a consumer under certain circumstances.<sup>18</sup> These activities include:

- Sharing nonpublic personal information to effect, administer, or enforce a transaction requested or authorized by the consumer, or in connection with servicing or processing a financial product or service requested or authorized by the consumer, or in connection with maintaining or servicing the consumer's account with the financial institution;<sup>19</sup>
- Sharing nonpublic personal information to protect against or prevent actual or potential fraud, identity theft, unauthorized transactions, claims, or other liability;<sup>20</sup>
- Sharing nonpublic personal information to comply with federal, state, or local laws, rules, and other applicable legal requirements; to comply with a properly authorized civil, criminal, administrative, or regulatory investigation or subpoena or summons by federal, state, or local authorities; or to respond to judicial process or government regulatory authorities having jurisdiction over the financial institution for examination, compliance, or other purposes as authorized by law;<sup>21</sup>
- Sharing nonpublic personal information with an affiliate or a non-affiliated third party for the affiliate or non-affiliated third party to perform business or professional services;<sup>22</sup>
- Sharing nonpublic personal information in connection with a written agreement between a consumer and a broker-dealer registered under the Securities Exchange Act of 1934, as amended, or an investment adviser registered under the Investment Advisers Act of 1940, as amended, to provide investment management services, portfolio advisory services, or financial planning and the nonpublic personal information is released for the sole purpose of providing the products and services covered by that agreement.<sup>23</sup>

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<sup>17</sup> See Section 4053(d)(3) of the CFIPA.

<sup>18</sup> See Sections 4052.5, 4053(a)(1), and 4053(b)(4) of the CFIPA.

<sup>19</sup> See Section 4056(b)(1) of the CFIPA.

<sup>20</sup> See Section 4056(b)(3)(B) of the CFIPA.

<sup>21</sup> See Section 4056(b)(7) of the CFIPA.

<sup>22</sup> See Section 4056(b)(9) of the CFIPA. The following additional conditions are imposed: the services to be performed by the third party may lawfully be performed by the financial institution; (ii) there is a written contract that prohibits the third party from disclosing or using the information other than to carry out the purpose for which the financial institution disclosed the information; (iii) the information provided to the third party is limited to that which is necessary for the third party to perform the services; and (iv) the financial institution does not receive any payment in return for the release of the information.

<sup>23</sup> See Section 4056(b)(14) of the CFIPA.

## Penalties

A financial institution that negligently discloses or shares nonpublic personal information would be subject to a civil penalty of up to \$2,500 per violation.<sup>24</sup> If a financial institution negligently discloses the nonpublic personal information of more than one person, then the total civil penalty would be up to a maximum of \$500,000.<sup>25</sup> Finally, a financial institution that knowingly and willfully obtains, discloses, shares or uses nonpublic personal information in violation of the CFIPA would be subject to a civil penalty of up to \$2,500 per violation.<sup>26</sup>

## Impact on Hedge Fund Managers

Hedge fund managers collect nonpublic personal information from their natural person investors because the typical subscription document that a hedge fund investor completes requests that the investor furnish his or her name, address, telephone number, e-mail address, social security number, and income. Furthermore, it is commonplace for a fund manager to share nonpublic personal information in order to complete a transaction and to service an investor's account. Instances when a fund manager shares a consumer's nonpublic personal information include:

- Sharing nonpublic personal information with a broker-dealer to complete the subscription;
- Sharing nonpublic personal information with a finder, placement agent, or solicitation agent to complete the subscription;
- Sharing nonpublic personal information with the fund's administrator to process the subscription and to satisfy anti-money laundering obligations;
- Sharing nonpublic personal information with a bank to complete a transaction;
- Requesting legal counsel to review completed subscription documents to ensure compliance with the accreditation rules, ERISA and the anti-money laundering regulations;
- Sharing nonpublic personal information with a bank or other entity that is qualified custodian in connection with satisfying the custody rules under the Investment Advisers Act of 1940, as amended;<sup>27</sup> and
- Sharing nonpublic personal information between the general partner or managing member of the fund and its investment manager affiliate.

Although it is typical for a hedge fund manager to collect nonpublic personal information and to share it, as long as the fund manager is sharing their investors' nonpublic personal information under circumstances similar to the situations described above, then the sharing of nonpublic personal information should fall within the exemptions described under Section 4056 of the CFIPA. Accordingly, regardless of the location of its home office, such a fund manager doing business in California should not be required to provide an opt-in or an opt-out to its investors who are residents of California.

However, if a fund manager is sharing nonpublic personal information in situations other than as described under Section 4056 of the CFIPA, then a fund manager would be required to provide an opt-in and/or an opt-out to its investors who are California residents.

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<sup>24</sup> See Section 4057(a) of the FCIPA.

<sup>25</sup> See Section 4057(a) of the FCIPA.

<sup>26</sup> See Section 4057(b) of the FCIPA.

<sup>27</sup> See Rule 206(4)-2 of the Advisers Act.

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If you have any questions or comments regarding the California Financial Information Privacy Act or compliance with the federal privacy laws in general, please feel free to contact:

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