
Hot Issues for Directors: Director Oversight Responsibilities—Cybersecurity and the Volcker Rule

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February 20, 2014

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Director Oversight Responsibilities under the Volcker Rule

What We Will Cover

- General overview
 - The Purpose of the Rule
 - The Rule
- Impact on the financial services industry
- Implementation oversight responsibilities imposed on directors

Reason for the Rule

- While Congress was considering what would become the Dodd-Frank Act, the President met with
 - Former Federal Reserve Chairman Paul Volcker and
 - Former SEC Chairman Arthur Levitt.
- The White House issued a press release that did not purport to address the causes of the financial crisis.
 - It is “inappropriate” for proprietary trading and investment and sponsorship of hedge funds and PEFs to be conducted by firms that have the federal safety net.
 - Access to FDIC deposit insurance
 - Access to the Federal Reserve discount window
- But banks pay for deposit insurance.
- But the Volcker Rule covers affiliates of banks, and those affiliates do not have deposit insurance or access to the discount window.
- That was the genesis of Section 619 of the Dodd-Frank Act.

The Volcker Rule

- Statute is Section 619 of the Dodd-Frank Act which is called “the Volcker Rule.”
 - Implementing regulations were not adopted until December 10, 2013
- Two prohibitions
 - Prohibit “proprietary trading” by “banking entities”
 - Exceptions
 - Trades at the order of customers
 - Market-making
 - Hedging
 - Prohibits ownership or “sponsorship” of “hedge funds and private equity funds” by banking entities
 - Ownership is to be divested by July 21, 2014 unless the Federal Reserve Board extends that deadline.
 - Exception
 - Organizing and offering funds for trust or investment advisory customers
 - » Not necessarily pre-existing customers

Definitions

- “Proprietary trading”
 - Acquiring, as principal, securities, derivatives, commodities futures contracts, or options for the purpose of selling in the near term or to profit from short-term price movements
 - If your banking entity does not engage in proprietary trading, it is not affected by this aspect of the Volcker Rule.
- “Banking entity”
 - Bank
 - Affiliate of bank
 - Controlled by a bank
 - Controlling a bank
 - Under common control with a bank

Definitions, continued

- “Sponsor”
 - Serving as general partner, managing member, or trustee of a fund
 - Selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of a fund
 - To share a name or a variation thereof with a fund
- “Hedge funds and private equity funds”
 - Issuers that would be deemed “investment companies” under the Investment Company Act of 1940, but for exemptions in that statute for funds that have less than 100 investors or only qualified investors.
- If your banking entity does not invest in funds or sponsor them, you need not worry about this aspect of the Volcker Rule.

One Highly-publicized Issue

- The final rule also exempts funds that hold only debt.
- However, some collateralized debt obligation (CDO) pools hold some securities to increase yield.
 - Some CDO pools hold trust preferred securities (“TruPS”) issued by bank affiliates.
 - Some banking entities have invested in such CDOs.
- The effect of adoption of the final rule was to require divestiture of such CDOs by July 21, 2014.
- That required a change in the accounting treatment of such investments requiring them to be moved to “available for sale” status.
- That required that their carrying value be marked to market.
- Since the market for TruPS has declined, the adoption of the rule on December 10 had the potential effect of requiring many banking entities invested in CDOs invested in TruPS to realize a surprise fourth quarter loss.
- However, on January 14, 2014, after a lawsuit was filed against the Federal Reserve and while fourth quarter 2013 financials were being prepared, the Federal Reserve revised the December 10, 2013 final rule to permit banking entities with less than \$15 billion in assets to hold CDOs that hold TruPS.

Another Effect of the Fund Ownership Interest Prohibition

- A banking entity cannot hold an “ownership interest” in a PEF or hedge fund.
 - “Ownership interest” = equity interest, partnership interest, “or similar interest”
 - “Similar interest” includes a holding of debt issued by the fund if the holder has a right to remove the manager or a director of the fund (other than for an event of default or acceleration)
 - Q: right to remove director of a fund for cause
 - A common provision in collateralized loan obligations (CLOs)
 - This, in effect, ironically precludes banking entities that are investors in CLOs from being able to remove CLO managers or directors who engage in fraud!
- The agencies have a joint task force working on Volcker issues that may arise.
 - That task force may well address this issue.

Directors are Affected by One Exception to the Fund Prohibitions

- Funds offered to trust and investment advisory customers are exempt.
 - However, 7 other conditions must be met to take advantage of this exemption, including
 - No director or employee of the banking entity may take or retain an ownership interest in the fund
 - Unless he or she is directly engaged in providing services to the fund.
 - Thus, unless you provide services to the fund, you, as a director of the banking entity, may not hold an ownership interest in the fund.
 - No later than 1 year after establishment of fund, the banking entity ownership interest may not be more than 3% of the ownership interests in the fund, and the aggregate of such interests in all such funds shall not exceed 3% of the banking entity's Tier 1 capital
 - New regulation: if service-providing director borrows from the banking entity or if the banking entity guarantees the director's investment, the service-providing director's shares count toward these 3% caps.

Directors Are Also Affected by the Fund Sponsorship Prohibition

- Sponsorship is defined to include having directors that constitute a majority of the directors, trustees, or management of a fund.
- Thus, the rule may prohibit a banking entity director from being a manager of a hedge fund or private equity fund.

New Director Compliance Oversight Responsibilities

- The board of directors of a banking entity is to review the effectiveness of the entity's Volcker Rule compliance program.
 - Questions to ask
 - Has management benchmarked its Volcker Rule compliance program against those of similar institutions?
 - Has management verified with the regulator examiner-in-charge whether the program appears to be sufficient?
 - What will be management's process to update the board on compliance with the Volcker Rule?
 - Is it possible that Volcker Rule compliance by the industry will cause market disruptions? If so, has management taken that into account?
 - Which executive has ultimate responsibility for Volcker Rule compliance? If the responsibility is shared, how are the responsible executives coordinating?

New Director Compliance Oversight Responsibilities, continued

- The banking entity is to provide prompt notification to the board of directors of sustained weaknesses or significant deficiencies in the implementation of the Volcker Rule compliance program.
 - Questions to ask
 - What is being done to correct the weaknesses?
 - When will the corrective actions be effective?
 - Are the deficiencies likely to cause the firm financial or reputational harm?
 - Are we putting in place systems to prevent future deficiencies?

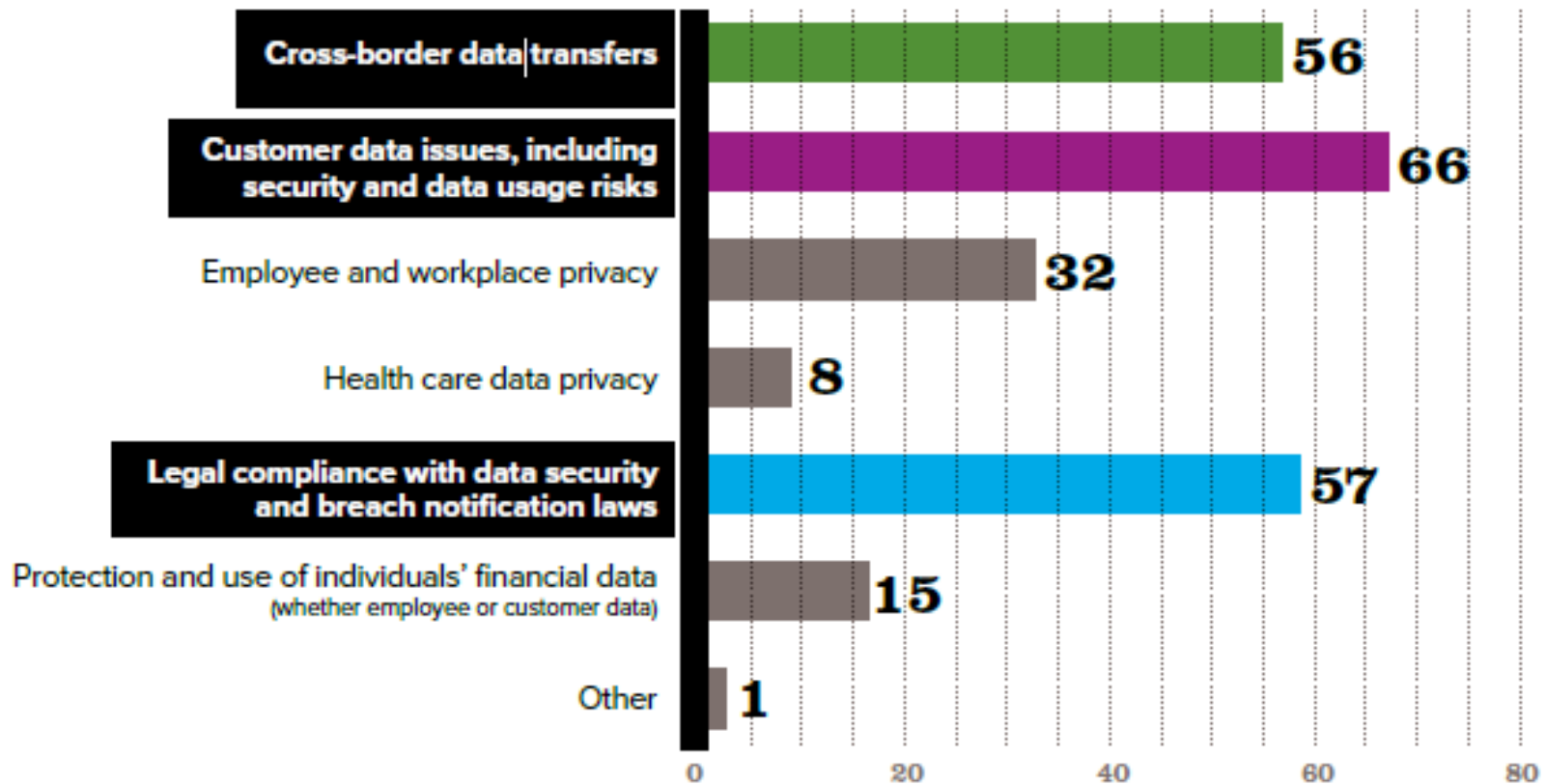
New Board Responsibilities

- The board of directors is responsible for creating an appropriate “tone at the top” by setting an appropriate culture of compliance and establishing clear policies regarding the management of the firm’s trading activities and its fund activities and investments.
- The potential for civil money penalties, prohibition of continued service, removal from office, and personal cease and desist orders applies to directors.

CLE Presentation Code

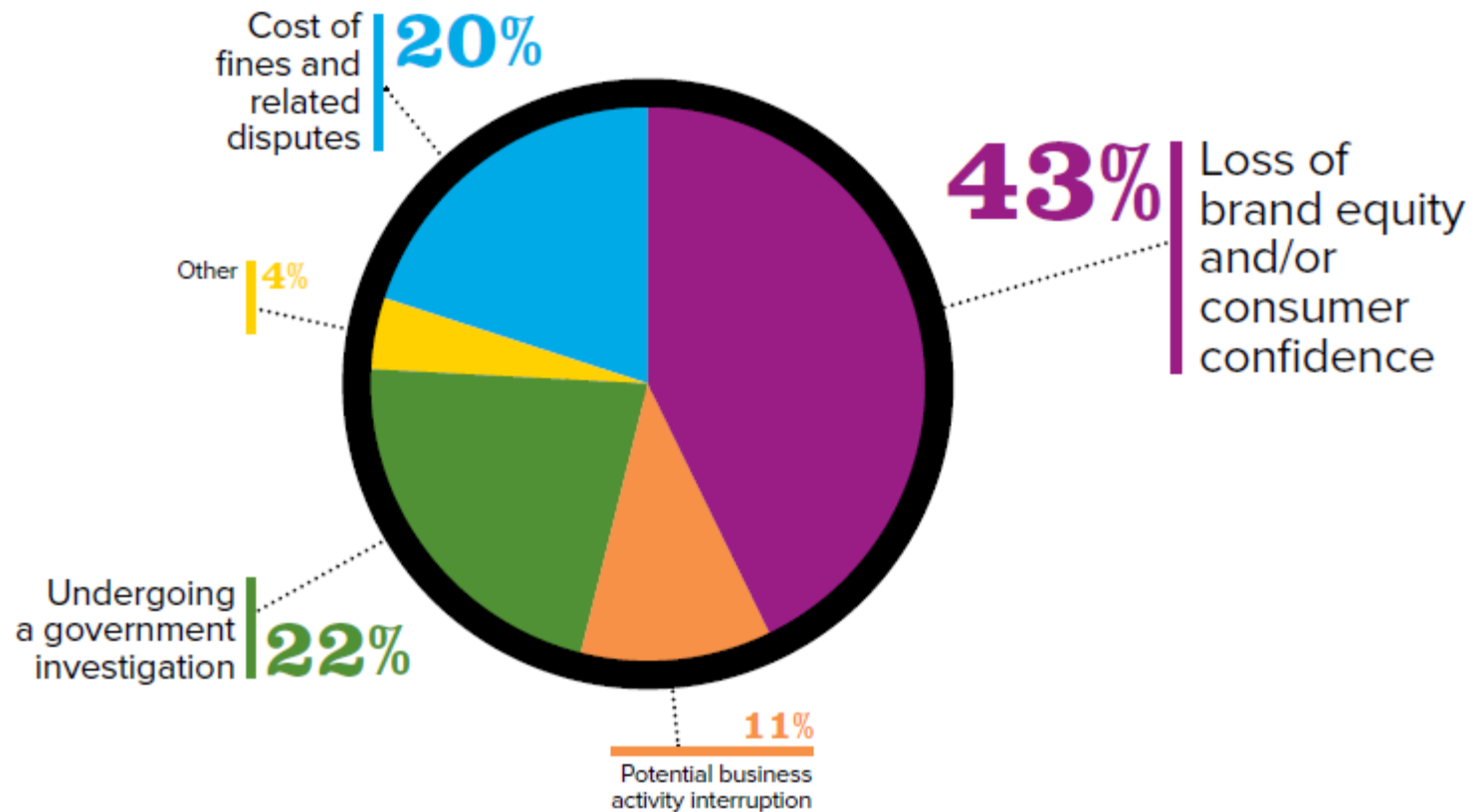
Directors Responsibilities: Cybersecurity and Information Security

Top Data Privacy Concerns Today



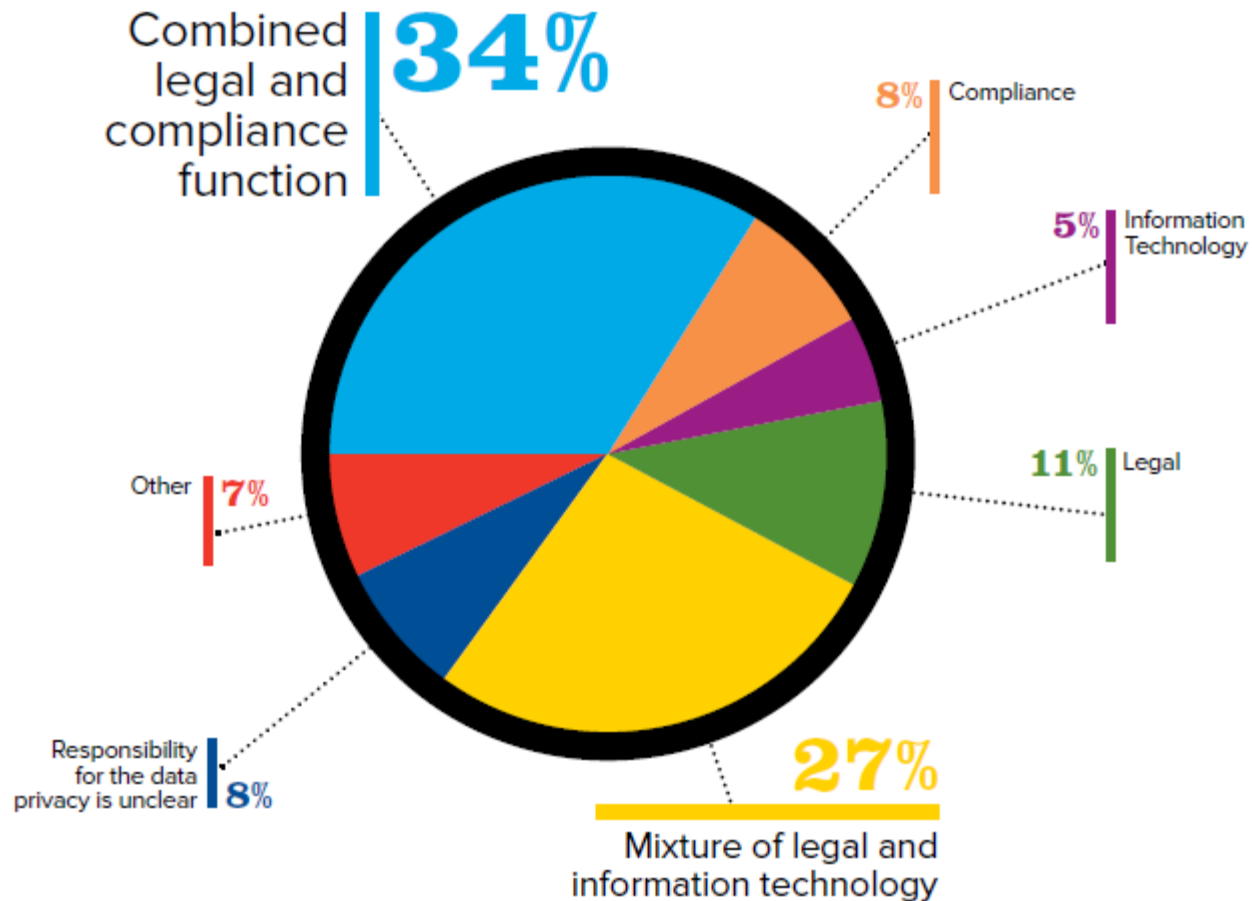
From *The Winston & Strawn International Business Risk Survey 2013*

Primary Concern Driving Compliance



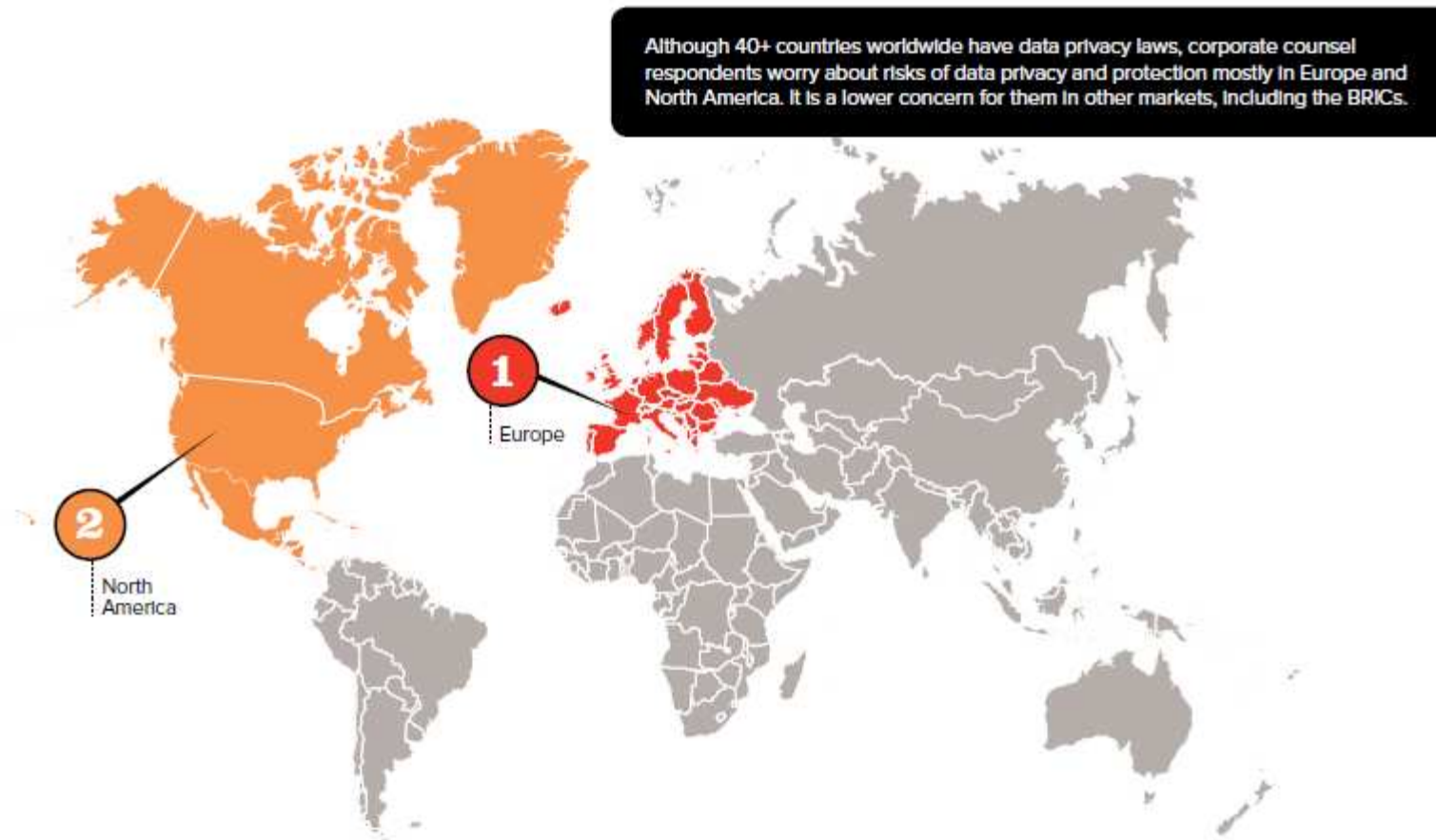
From *The Winston & Strawn International Business Risk Survey 2013*

Who Handles Compliance?



From *The Winston & Strawn International Business Risk Survey 2013*

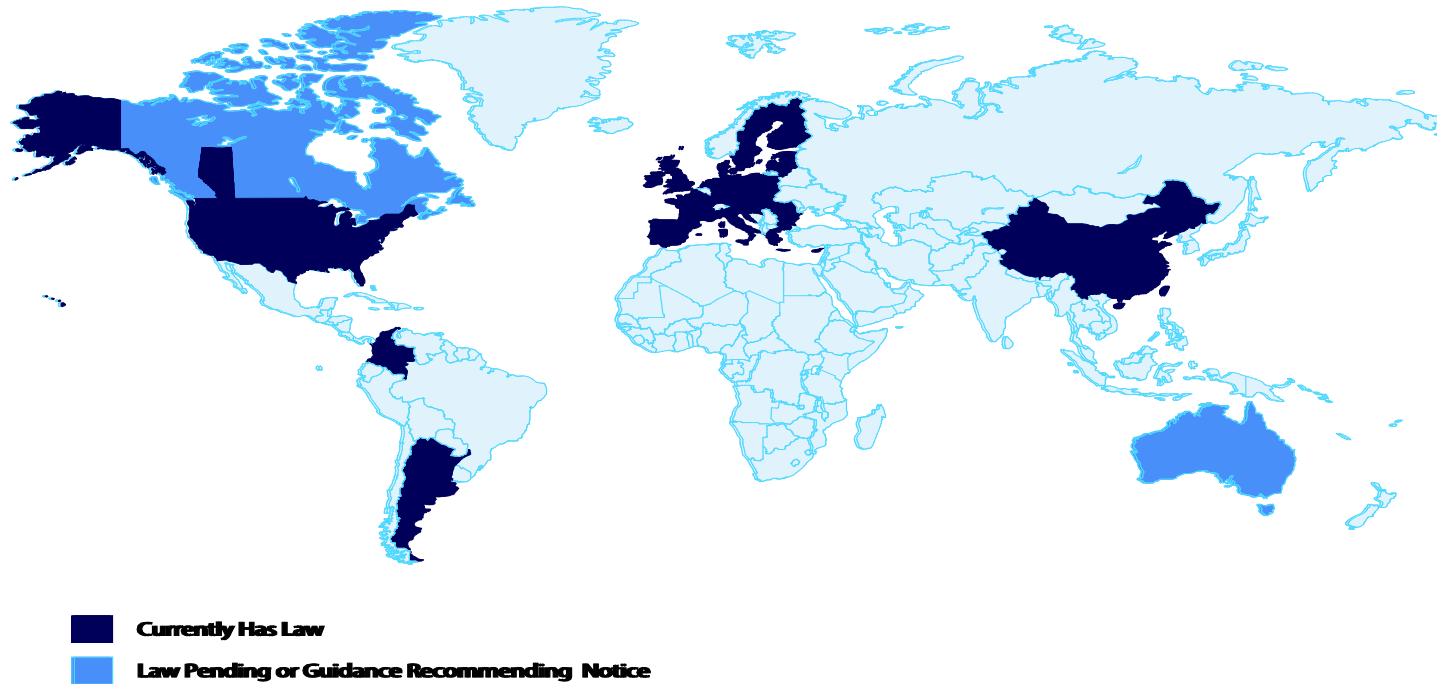
Perceived Greatest Threats



From *The Winston & Strawn International Business Risk Survey 2013*

-
- 1. Data Breach Laws: What Should Every Director Know?**
 2. Data Security Challenges: What Should Every Director Ask?
 3. Reliance on Mobile: Should Directors Worry?

Breach Laws Are Going Global



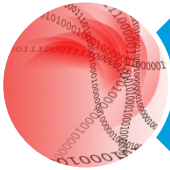
Does the Company have an Investigative Plan?



Secure the data



Preserve evidence



Analyze forensic data



Interview key witnesses

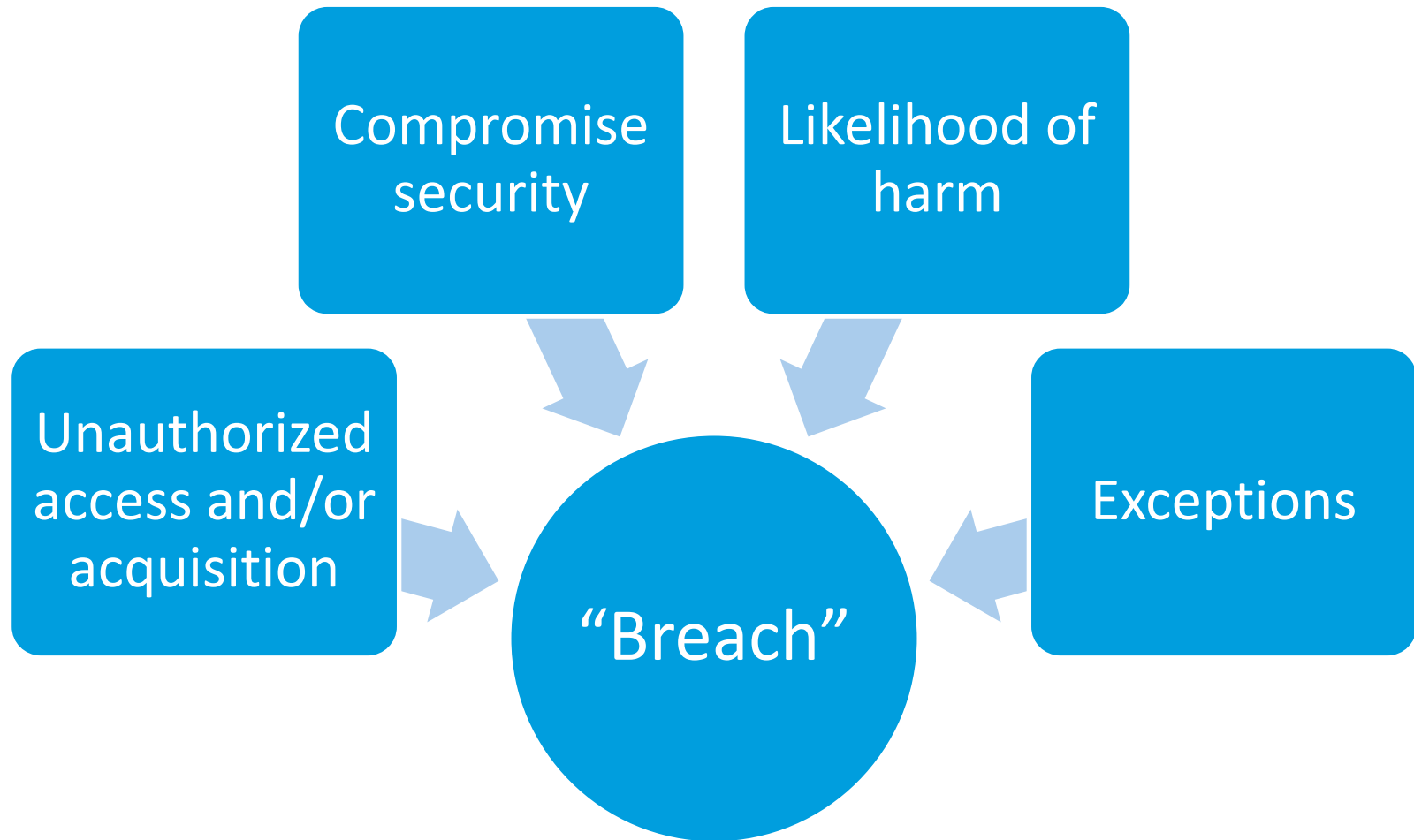


Document security controls

Has the Company Thought About Privilege?

- As you investigate, facts may become more damning
- Could be other things in the data sets
 - Proposed business plans
 - Trade secrets
 - And more
- Retained faster/investigation quicker
- Hire experts (including investigators) under privilege
 - Keep under the “direction of counsel”

What Will Be Investigated?



If Laws Impacted, Notice Will Be Needed



What Notices Look Like

Describe incident

Categories of information

Consequences of breach/nature of risk

Protection measures put in place

- Steps to investigate, mitigate harm

Advice about how to protect self

- Contact information for law enforcement
- Where to get more information

Does the Company Have a PR Strategy Ready?

- What happened?
- When did it happen?
- What information was compromised?
- Was my information compromised?
- How many people's information was impacted?
- Was the information encrypted?
- Was my social security number compromised?
- Did anyone misuse this information?
- What should I do?
- What are you doing to protect me?
- Why aren't you taking other measures to help?
- What are you doing to protect others?
- Will this happen again?
- Who should I contact if I have more questions?

Is the Company Ready for What's Next?

- Victims of breach are **litigation targets**
 - FTC
 - State AGs
 - SEC
 - Shareholders
 - Customers

Fed Regulators





State Regulators



Securities



SEC

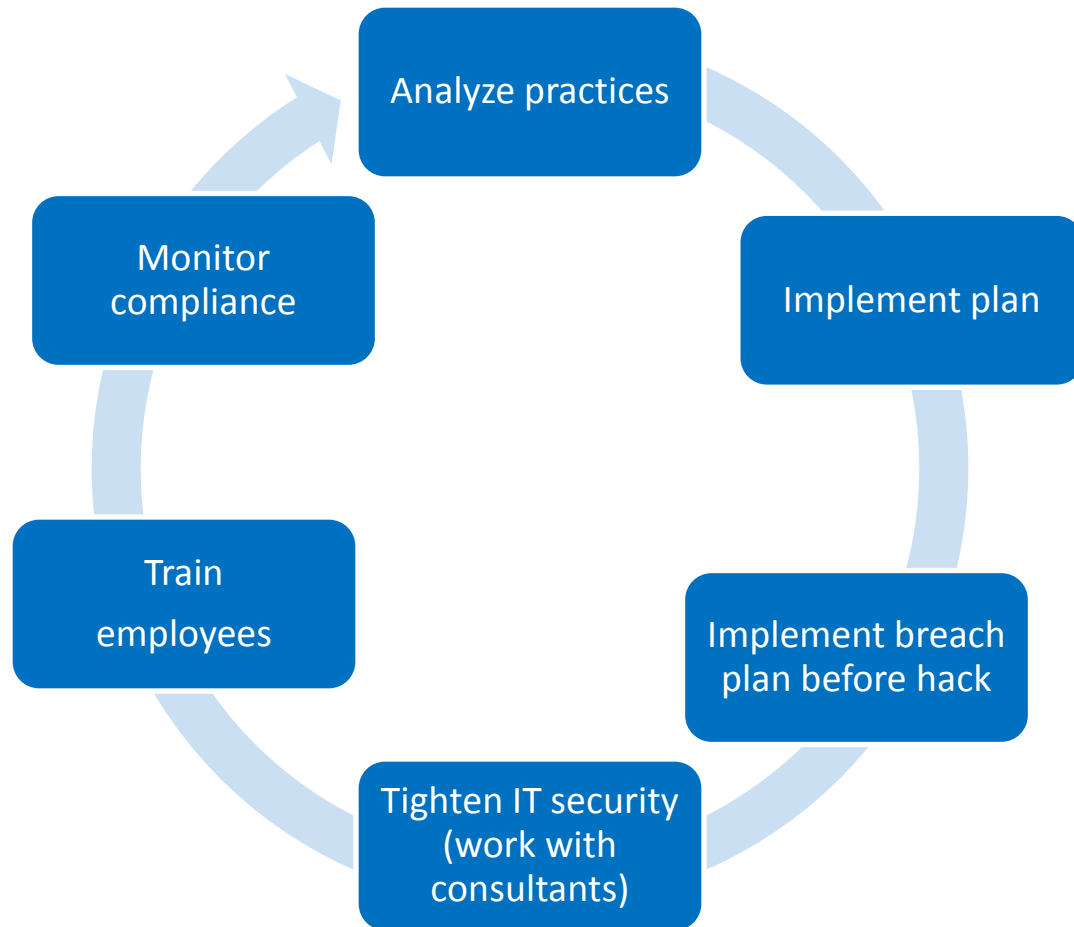


Shareholder

Hot Area for Plaintiff's Lawyers



Does Company Know How to Create Appropriate Plan?



-
1. Data Breach Laws: What Should Every Director Know?
 - 2. Data Security Challenges: What Should Every Director Ask?**
 3. Reliance on Mobile: Should Directors Worry?

Is Our Data Sufficiently Secure?



Who Is Doing It, and How?

- Who does this?
 - 92% outsiders
 - 19% state-affiliated
- How do they do it?
 - 52% hacking
 - 76% stolen credentials
 - 40% malware
 - 29% leverage social attacks

(from *Verizon Report*)

Organized Crime



Hacktivists

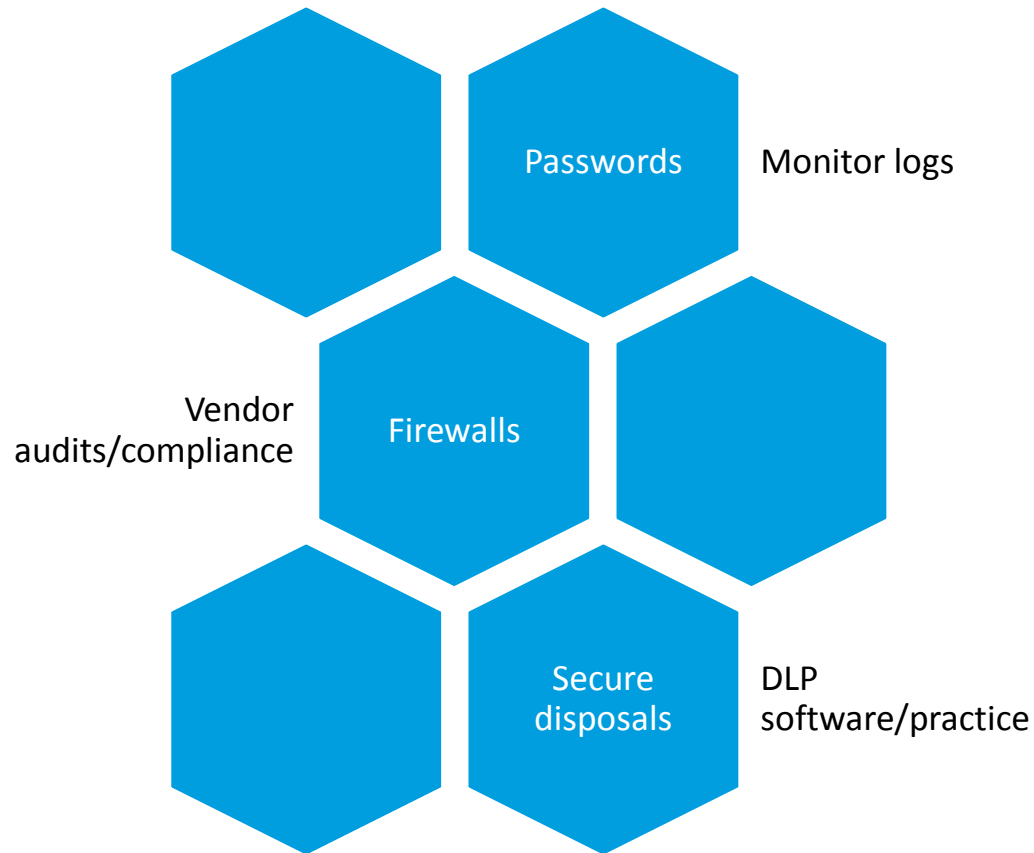
Nation-State Hacking



Tools of the Trade

- **Trojan** – malicious code surreptitiously inserted into target computer to allow remote access/control by unauthorized person
- **Botnet** – network of infected computers controlled remotely
- **Phishing** – common infection technique involving email that lures user to take action that unwittingly downloads malicious code
- **Drive-by infection** – infection of internet sites so that user clicking on button on web page unwittingly downloads malware
- **Backdoor** – creation of means for unauthorized and undetected access
- **Keylogger** – software tool that logs keystrokes

Protection Against Hacking?



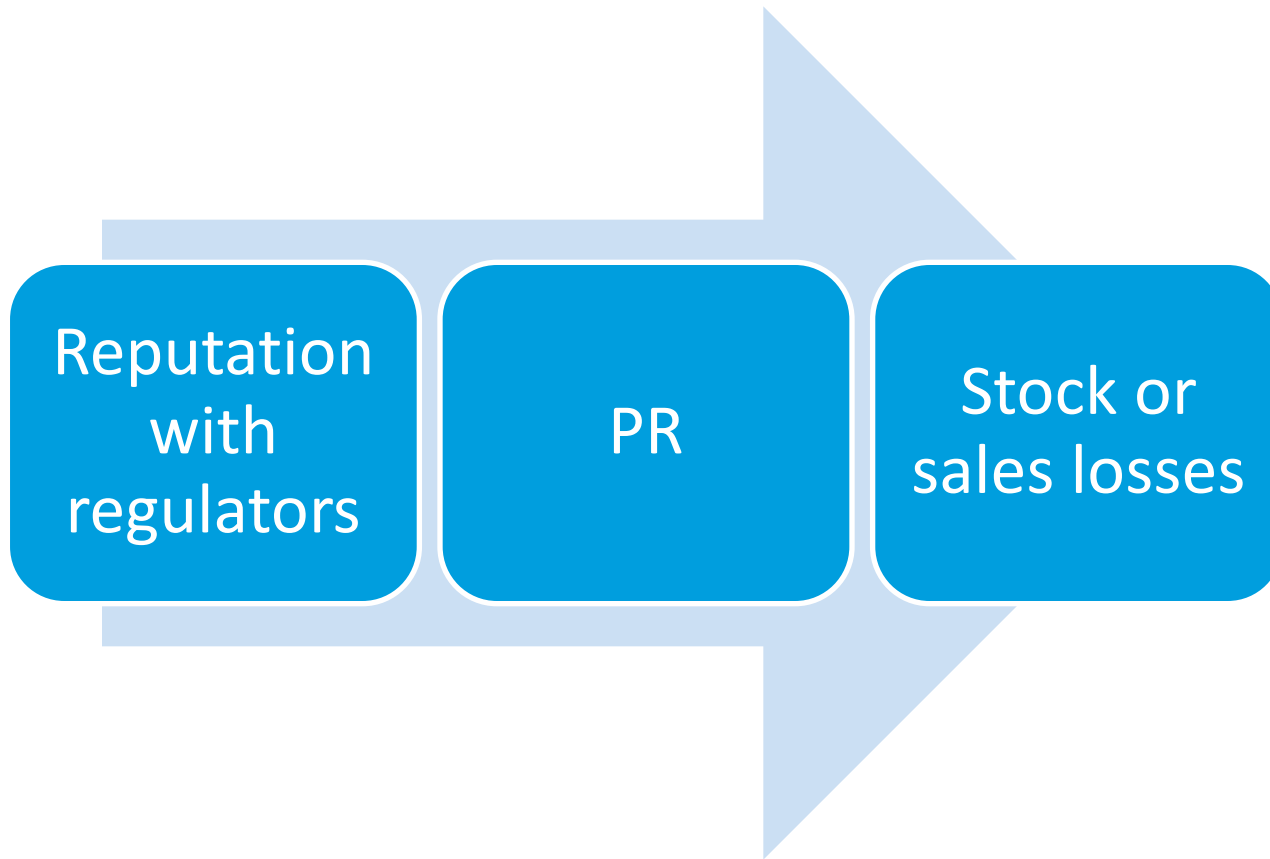
Employees, Consultants, Vendors



How to Protect Your Company

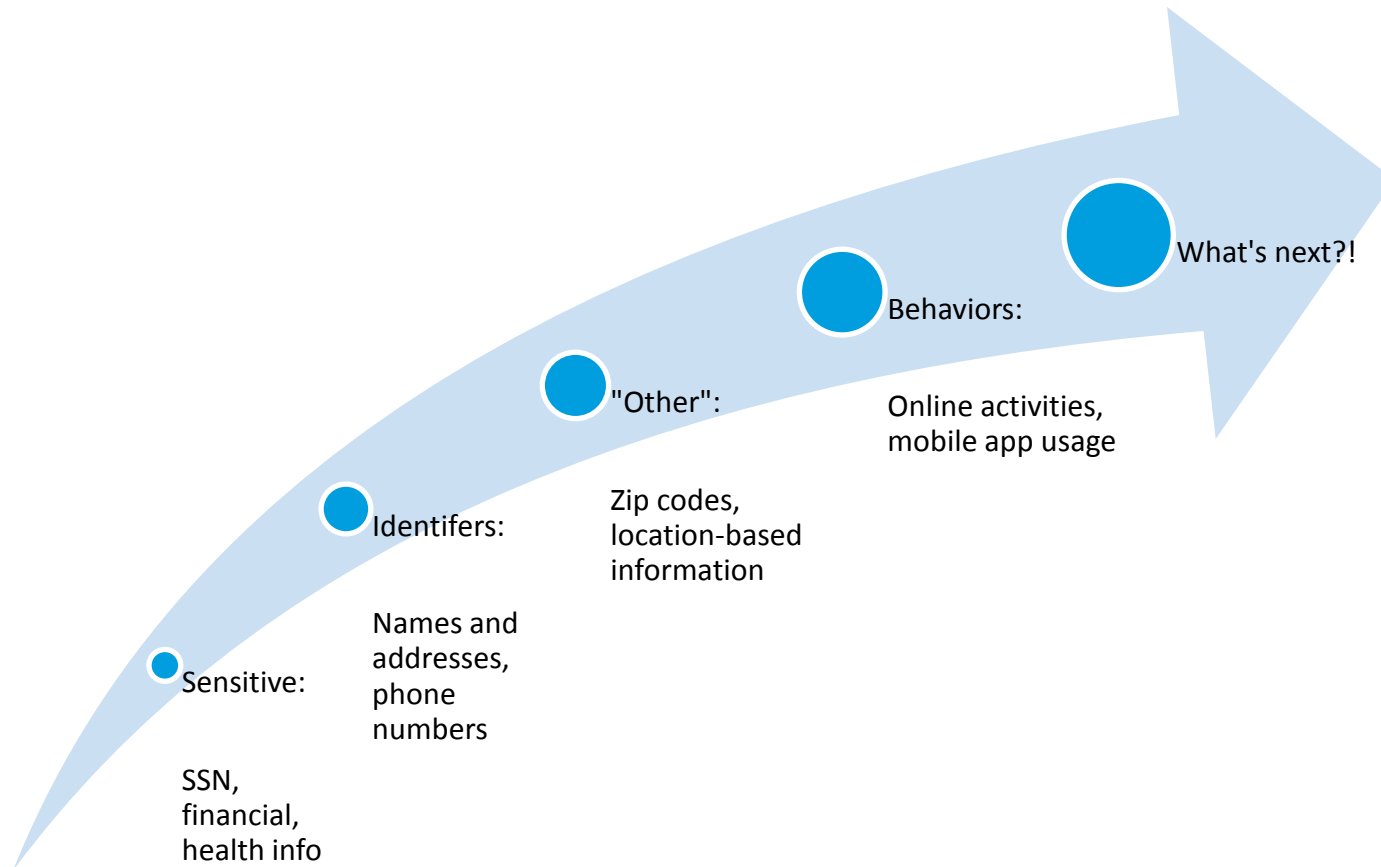


Why You Care: Costs



-
1. Data Breach Laws: What Should Every Director Know?
 2. Data Security Challenges: What Should Every Director Ask?
 - 3. Reliance on Mobile: Should Directors Worry?**

Does the Company Know What is Personal?



Should We Worry?



Google

\$22.5 Million



quantcast

\$2.4 Million



Path

\$800,000



ChoicePoint

\$15 Million

Why is Notice so Important?



Honesty

Transparency

What About Choices?



Are There Tracking Laws in the US?

- State wiretap
- State adware
- Federal wiretap

Eavsdropping



- FTC Act
- State deception laws

Deception

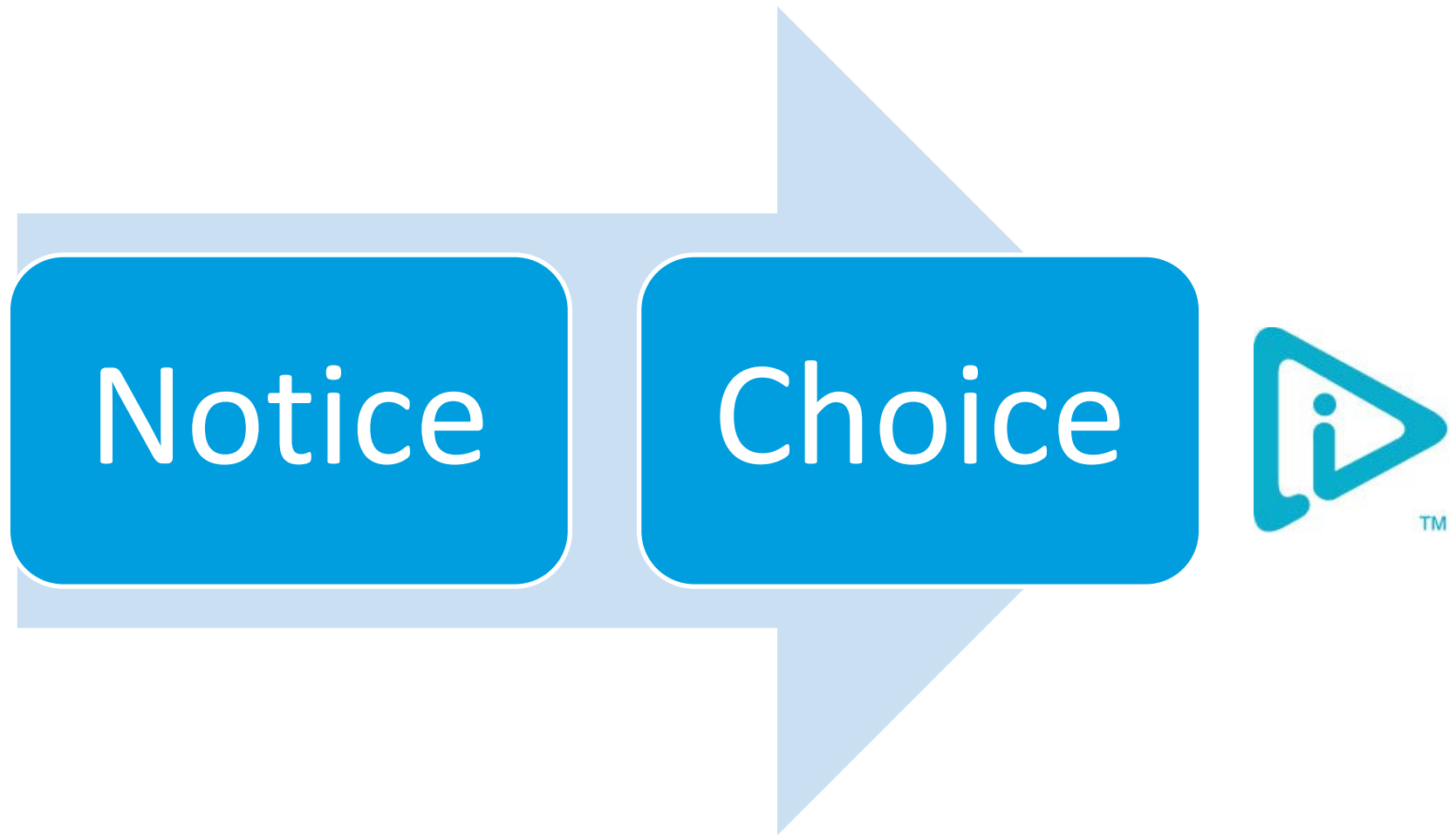


- Updated Rule July 1

COPPA



Self-Regulation



Websites: The In-Ad Notice

Logo in Ad:

A hyperlink



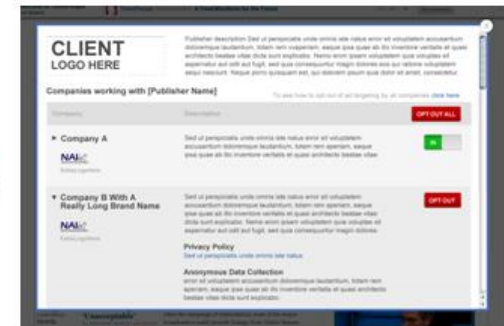
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FOR CONSUMERS

The Web sites you visit work with online advertising companies to provide you with advertising that is as relevant and useful as possible. Some of the online ads you are served may be based on the content of the Web page you're visiting; some others may be based on registration information you provide; and other ads may be customized based on predictions about your interests generated from your visits to other Web sites.

Who placed this ad?

- This ad was served by [Yahoo!](#).

Where can I learn more about how Yahoo! selects ads?

- Please read about [Yahoo's privacy and advertising practices](#).
- Yahoo! may use your [searches](#), demographics data, and location information to select the ads you see. To manage your location, please visit [Yahoo's Location Management page](#).

What choices do I have about interest-based advertising from Yahoo!?

- Manage** interest-based advertising categories, or opt-out of all categories, from Yahoo!
- Visit the [Network Advertising Initiative](#) and the [Digital Advertising Alliance](#) to see your opt-out choices from other participating companies.

Learn More!

- Find out about how online advertising [supports the free content, products and services you use online](#).
- [Understand your choices](#) for online advertising from the Digital Advertising Alliance.
- [Learn](#) more about online advertising from the Network Advertising Initiative.
- [Explore](#) browser controls and plug-in tools to help set and maintain your privacy choices.

FOR ADVERTISERS AND PUBLISHERS

Yahoo! delivers custom solutions to build your brand and drive the response you want. Yahoo!'s industry-leading targeting tools turn audiences into customers, helping you reach the people who matter to your business and deliver the right message.

Yahoo! Advertising Solutions

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Web-Based Opt-Out



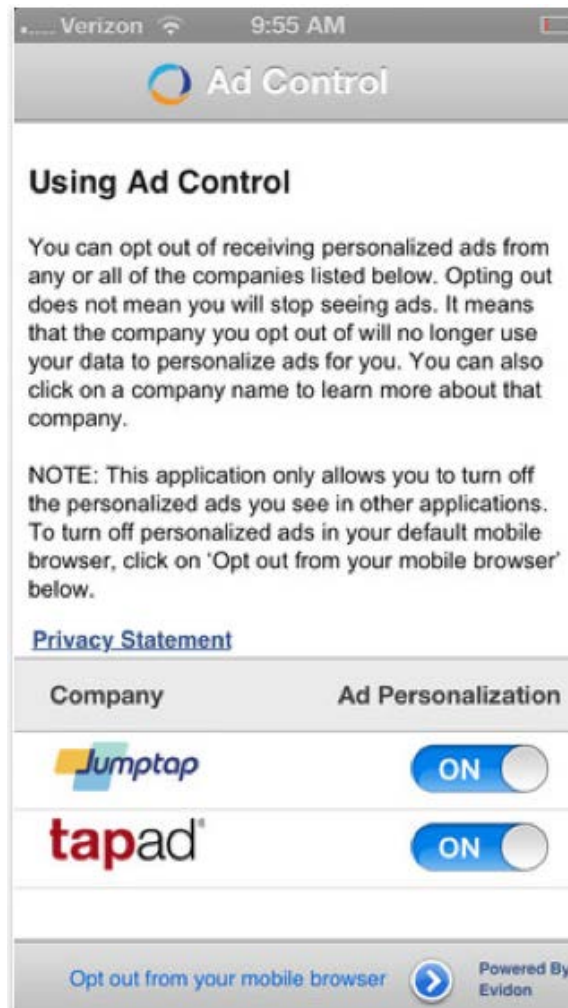
So Now...What About Apps?



Self-Regulation...Helpful?



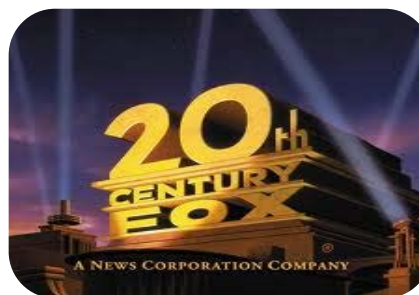
Choice ... Really?



Text Messages Particularly Risky



\$10 million



\$16 million



\$6 million

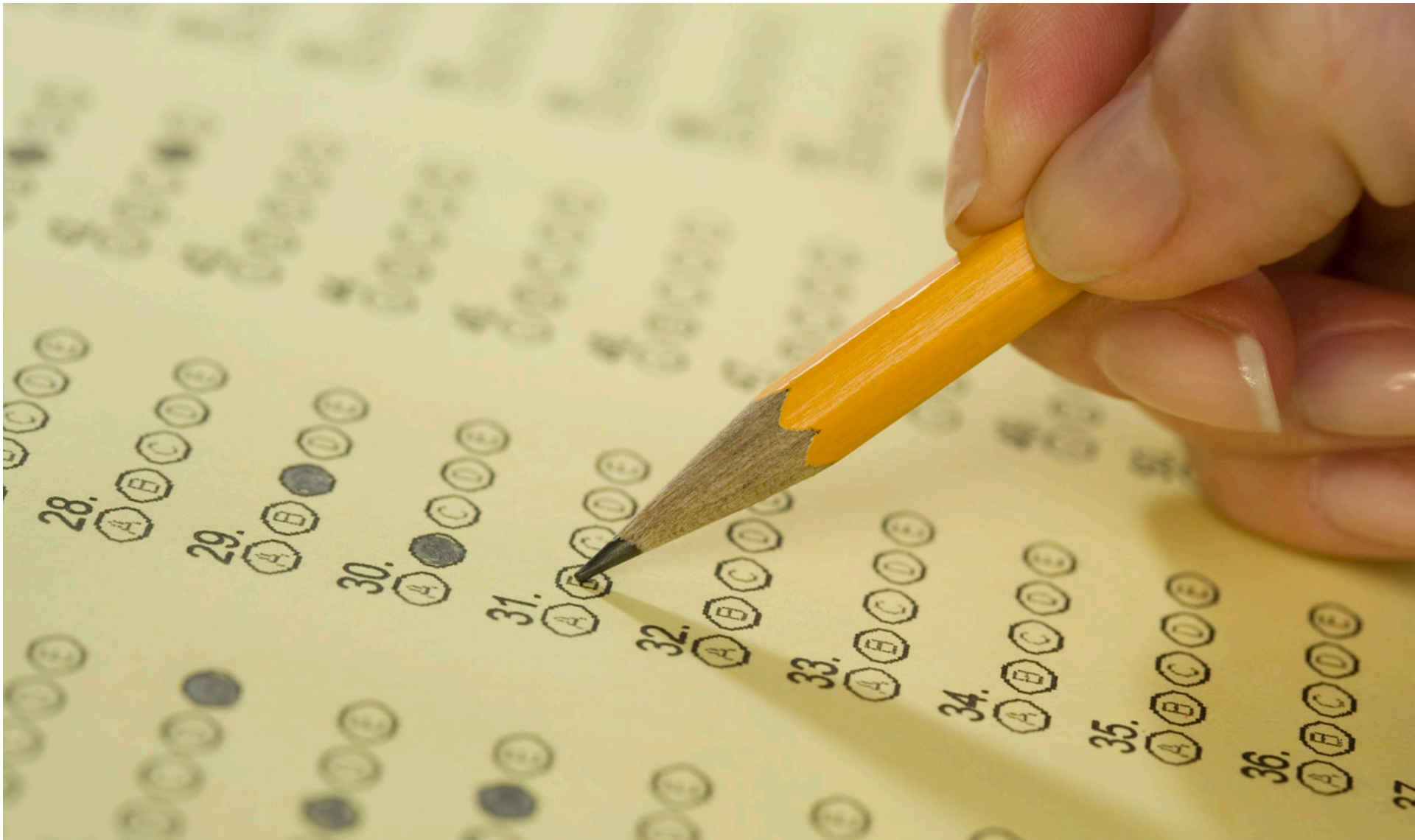


\$47 million



\$510,000

What is Consent?



What's Next? Stay Informed

- Winston Privacy Law News – Frequent Breach and Security Articles
 - Newsletter (US, Asia, Europe)
 - Twitter: @winstonprivacy
 - www.winston.com/privacylawcorner
- Publications
 - Thomas on Data Breaches (to be published in the Spring)
 - High Court May Tighten Reins On Data Breach Class Actions (by Steve Grimes, Law360)
- Breach “Crisis Simulation” Sessions
 - April, June, September

CLE Presentation Code

Questions?

Thank You

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