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Bank Boards of Directors Key Risks and Responsibilities in 2021: Actions Counsel Should Take Now

Climate Change, Cybersecurity, Access to Banking and Credit

TUESDAY, AUGUST 17, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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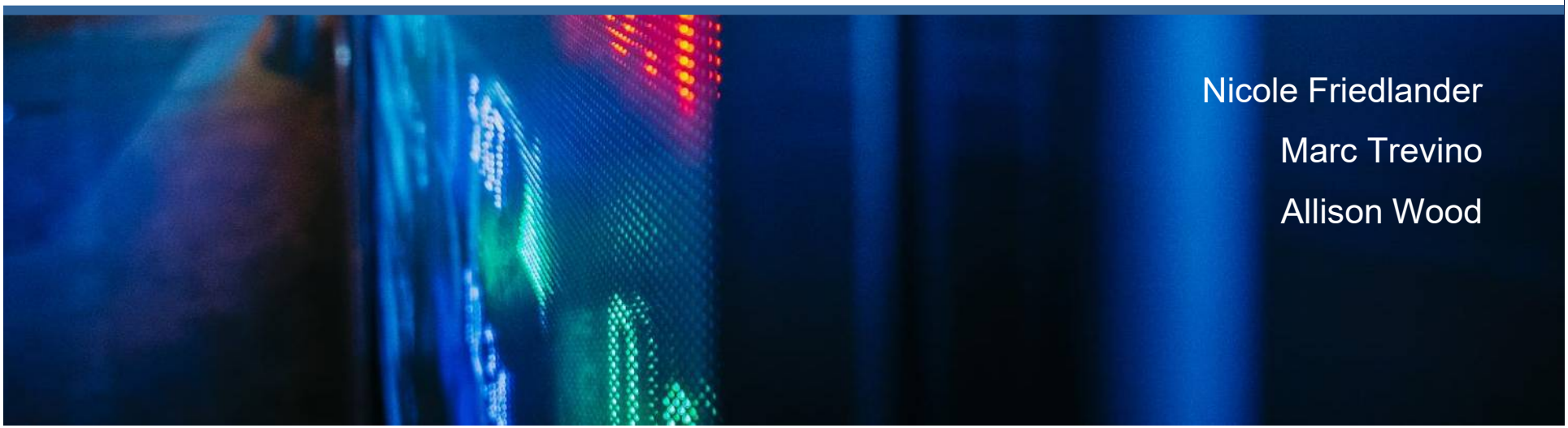
Bank Boards of Directors

Key Risks and Responsibilities in 2021

AUGUST 2021



Nicole Friedlander

Marc Trevino

Allison Wood

Agenda

1. Introduction to Legal and Regulatory Environment
2. Climate Change
3. Cybersecurity
4. Consumer Protection

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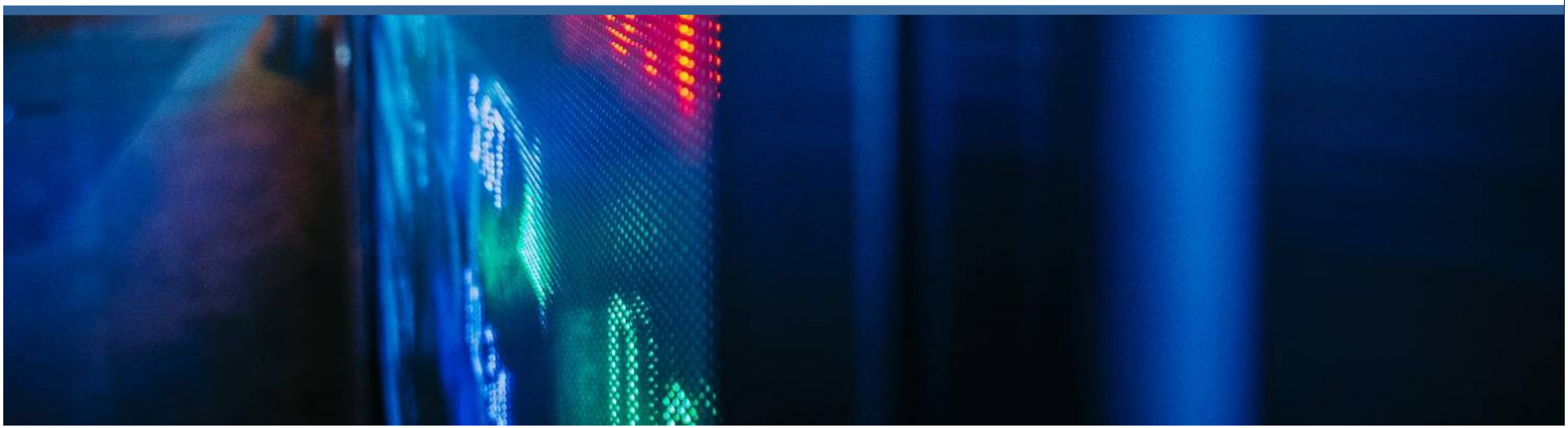
1 Introduction to Legal and Regulatory Environment



Introduction to Legal and Regulatory Environment

1. Continued refinement of post-crisis regulations through enforcement
2. Reinforcement of core supervisory pillars
3. Renewed push for consumer protection
4. Attention to new risk areas:
   - Climate
   - Digital currencies
   - Technology
   - Innovation

Advanced Preparation Toolkit

Attributes of an Effective Board	Notable Themes
1 **Set Clear, Aligned, and Consistent Direction Regarding the Firm's Strategy and Risk Appetite**	• alignment of a clear strategy and a clear **risk appetite** • consideration of **risk capacity** and **changes in risks** when overseeing strategy and **risk appetite** • clear allocation of responsibilities so that the board can evaluate senior-management performance
2 **Direct Senior Management Regarding the Board's Information Needs**	• timely and well-organized information that is sufficient in scope, detail, and analysis to enable the board to make sound, well-informed decisions and consider **potential risks** • training and information gathering outside of regular board meetings • active role in setting agendas, especially by the chairs
3 **Oversee and Hold Senior Management Accountable**	• oversight consistent with safety and soundness and in **compliance with laws**, including those related to consumer protection, under a range of conditions • robust inquiries by the board, including into (i) **current and emerging risks**, (ii) adherence to strategy and **risk appetite**, and (iii) material or persistent deficiencies in **risk management or controls** • oversight and evaluation of the performance and compensation of senior management
4 **Support the Independence and Stature of Independent Risk Management and Internal Audit**	• robust inquiries by **the RC and the AC**, including into (i) causes and consequences of material or persistent breaches of **risk appetite and risk limits**, (ii) timely remediation of material or persistent **internal audit and supervisory findings**, and (iii) **annual audit plan** • action by the board if the views of **independent risk management or internal audit** are not considered when decisions are made or if these functions are unduly influenced by business lines
5 **Maintain a Capable Board Composition and Governance Structure**	• consideration of whether the board's composition, governance structure, and practices support **safety and soundness** and the ability to promote **compliance with laws** • governance structure capable of overseeing senior management and addressing issues arising from the firm's size, scope of operations, activities, **risk profile**, and resolvability

Importance of Risk Oversight and Monitoring

- Ongoing risk oversight can help preserve company goodwill and brand value, which can contribute to directors' ability to maximize shareholder value over the long-term

- Ongoing risk oversight also will allow directors to satisfy their duties under the *Caremark* line of cases

- **As a result, proactive oversight and ongoing monitoring of important risk areas are crucial components of directors' fiduciary duties**

MARCHAND V. BARNHILL / CLOVIS ONCOLOGY

- These recent cases clarify that, in order to meet their *Caremark* duties, directors must be able to demonstrate that they:
  1. Have made good faith efforts to establish and implement board-level oversight procedures for their company's critical functions; and
  2. Actively monitor the oversight framework (particularly if the company operates in a regulated industry)
- While *Marchand* and *Clovis* do not specifically involve bank oversight issues, they do highlight the importance of regular board-level review and oversight of key risks facing the company

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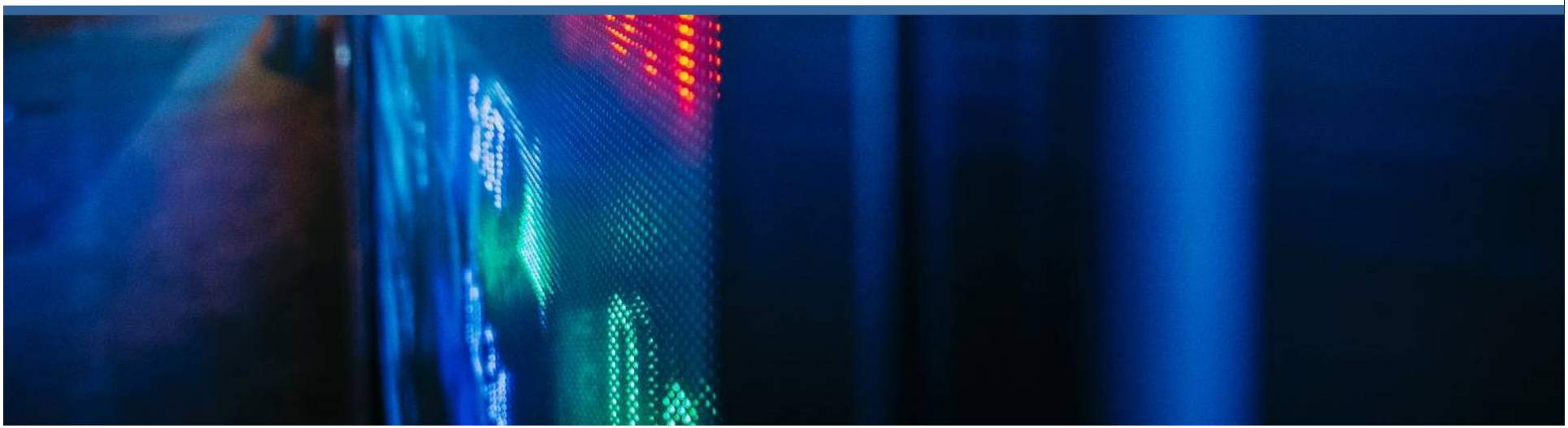
2 Climate Change

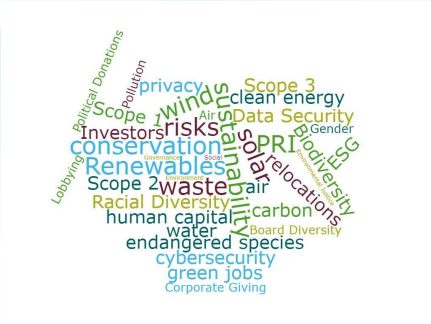


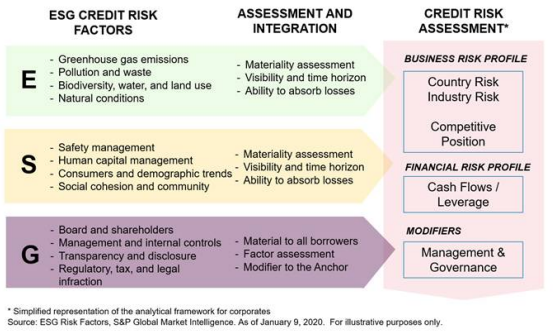
Climate Change Overview

1. Evolution of Climate Change and ESG
2. Increased Focus on Climate and Increased Risk
   - Whole of Government Approach
   - Investors
   - Shareholders

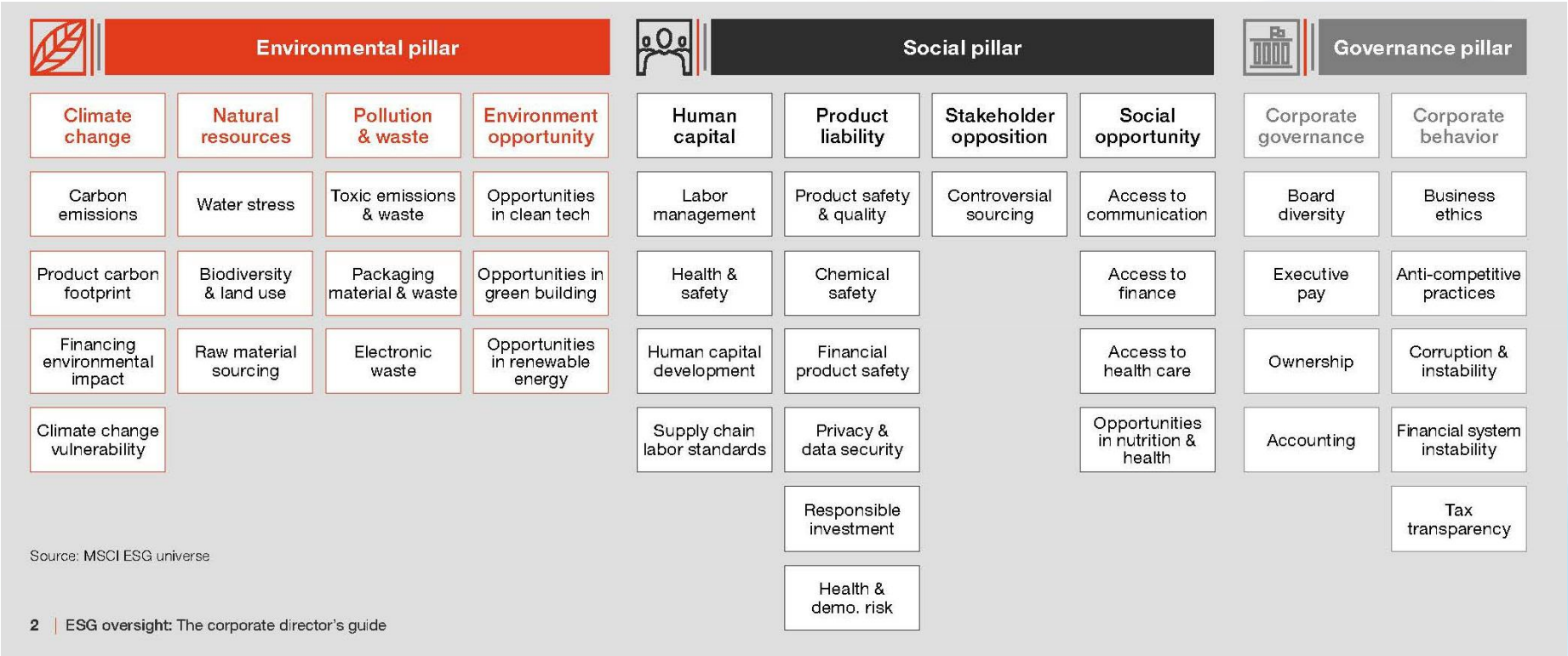
The Evolution of ESG and Emerging Risks

- Initial focus on climate and sustainability has given way to corporate social responsibility considerations
  - “E” disclosures and targets, like net-zero, are far more developed than “S” and “G” counterparts
- Expanding scope of ESG coverage and wide range of voluntary reporting platforms are responses to diverse demands from investors, consumers, and advocacy groups
- Biden administration brings new level of government interest in rules to govern ESG





The ESG Landscape



- *Source: PWC's ESG Oversight: The corporate director's guide (November 2020)*

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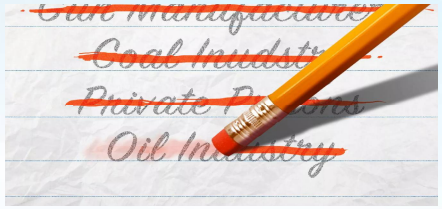
Access to Capital

- ESG disclosures increasingly drive finance and investment decisions
  - Institutional investors pledging to divest shares in companies that do not disclose ESG data
  - Lenders pressed to end financed greenhouse gas emissions

❖ ESG-Driven Investor Agenda

- ❖ Eliminate all investments in coal
- ❖ Emphasize low-carbon/ESG investments
- ❖ Secure corporate board commitments to climate action
- ❖ Achieve 2050 net-zero portfolio



❖ Reaction from Trump Administration

- ❖ "Guns and Oil" Rule
  - ❖ Comptroller of the Currency rule prohibits lenders from discriminating against "politically unpopular" businesses
- ❖ Labor Department ERISA Standards
  - ❖ Rule limits ESG funds in covered retirement plans

Momentum Behind New Rules

- Biden Administration expected to push robust ESG agenda
  - January 27, 2021 Executive Order on Tackling the Climate Crisis at Home and Abroad
    - "The Federal Government must drive assessment, disclosure, and mitigation of climate pollution and climate-related risks in every sector of our economy."
  - Treasury Secretary Janet Yellen advocates new climate policies
    - "Cap-and-dividend"
    - Climate stress tests for financial institutions
  - SEC Chair and Democratic Commissioners promising new ESG/climate disclosure rules
    - November 19, 2021 S-K Modernization Rule avoided any new climate or ESG-related obligations

SEC Taking Early Action

- SEC setting stage for major ESG initiatives
- Enforcement initiative, new regulations likely to set significant new precedent

https://www.sec.gov/sec-response-climate-and-eg-risks-and-opportunities

- Hired first full-time ESG specialist within Office of General Counsel
- Directed Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings"
  - New ESG and climate risk guidance expected
- Launched Climate and ESG Task Force in Division of Enforcement
  - Looking to "proactively identify ESG-related misconduct"
- March 15, 2021 Request for Public Comment on Climate Disclosure
  - Posed 15 questions regarding new ESG reporting requirements
- On July 26, SEC Chair Gary Gensler spoke at a Principles for Responsible Investment event sponsored by the UN and announced the agency expects to issue a proposed rule this year that would require public companies to disclose climate-related information

Investor Relations

- Highest number of shareholder proposals since we have been tracking
- Submissions on environment, social and political matters represent the majority of proposals for the first time
- Environmental proposals increased more significantly than any other category and climate proposals increased by 77%
- Many public companies preferred engaging with a shareholder proponent rather than taking a proposal to a vote given the voting policies articulated by BlackRock, Vanguard and State Street
- Average shareholder support for climate proposals that did go to a vote was a staggering 55%

Investor Relations

Continued

- A record 11 climate-related proposals passed in the first half of 2021
  - 5 requested disclosure of climate-related lobbying
  - 2 requested increased reporting on measures to address climate change
  - 4 requested GHG emissions targets
- 10 additional environmental proposals received between 30%-50% support
- Moody's and S&P have voluntarily adopted annual Say-on-Climate votes
  - 6 shareholder proposals requested Say-on-Climate at other companies

Activism – May 26

Big Oil's Bad, Bad Day

- Royal Dutch Shell ordered to reduce emissions
- Chevron shareholders vote cut Scope 3 emissions
- Exxon shareholders elect two dissident candidates, both pledge to push for climate action

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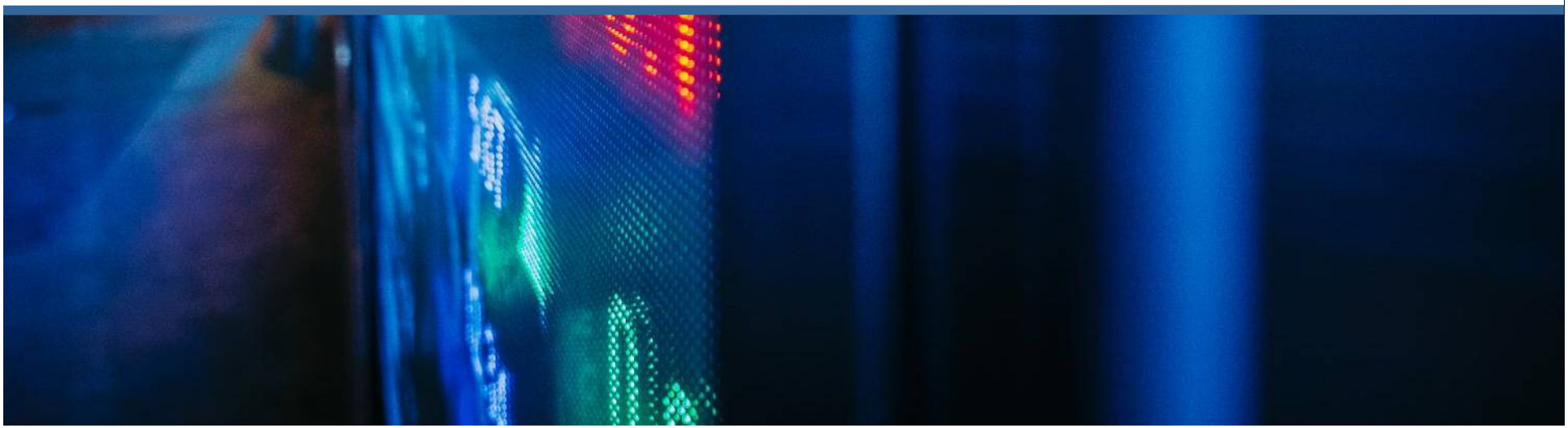
3 Cybersecurity



Cybersecurity Overview

1. DFS Guidance on SolarWinds
2. DFS Ransomware Guidance
3. SEC Enforcement: First American and SolarWinds Requests
4. Federal Bank Regulators' Notice of Proposed Rulemaking on Computer Security Incident Notification
5. President Biden's Executive Order on Improving the Nation's Cybersecurity

DFS Guidance on SolarWinds

Background

- Prominent recent example of “supply chain” attacks
- Malicious code was inserted into a software update that was sent to 18,000 SolarWinds software customers in March 2020
- The malicious code was exploited by Russia state-sponsored actors against many federal agencies and certain companies
- FireEye/Mandiant discovered the compromise in December 2020

DFS Guidance on SolarWinds

DFS Guidance

Continued

- On April 27, 2021, DFS made findings and recommendations based on its interviews of 88 companies
- According to DFS, companies should:
  - Identify critical vendors and have processes and contractual protections to ensure the vendors' cybersecurity is monitored;
  - Adopt a "zero trust" framework;
  - Implement a vulnerability management program; and
  - Include particular procedures in incident response plans

DFS Ransomware Guidance

- DFS surveyed 74 companies that reported a ransomware attack.
- Background facts in DFS report:
  - Increase in ransomware;
  - Increase in “double extortion”;
  - Increase in ransom amounts;
  - Insurance costs are rising; and
  - Insurers are scrutinizing their customers’ cybersecurity

DFS Ransomware Guidance

Continued

- DFS identified a "modus operandi" with respect to how ransomware perpetrators:
  - Gain access to companies' systems (*i.e.*, phishing, unpatched vulnerabilities)
  - Escalate privileges; and
  - Use elevated privileges to deploy ransomware, circumvent security controls, and target back-ups
- DFS made specific cybersecurity recommendations and clarified that companies must report ransomware attacks
- DFS is considering how to amend its cybersecurity regulation to incorporate this guidance

SEC Enforcement

First American – Background and DFS Enforcement

- DFS charged First American Title Insurance Co. in July 2020, the first action under its cybersecurity regulation
- A flaw in the company's public website made millions of confidential documents publicly accessible
- Company allegedly did not follow its own policy, did not fully investigate, and misclassified the issue's severity
- DFS's hearing is scheduled for August 2021

SEC Enforcement

First American – SEC Enforcement

Continued

- In June 2021, the SEC announced charges and a simultaneous resolution with First American, alleging:
  - A serious software vulnerability was not timely elevated within the company; and
  - Even after senior executives became aware of the vulnerability, they were not made aware before issuing a press release that the company had known of the vulnerability for months and failed to address it
- Charged with Rule 13a-15(a) for lacking disclosure controls and procedures

SEC Enforcement

SolarWinds Requests

Continued

- Days after issuing the First American action, SEC Enforcement Division sent requests seeking information about:
  - SolarWinds software versions and patches;
  - How companies discovered the compromised software;
  - Remedial measures taken; and
  - Other compromises companies may have experienced in a particular time period
- Offered a safe harbor for companies that discovered and timely disclosed any SolarWinds matter in the course of responding

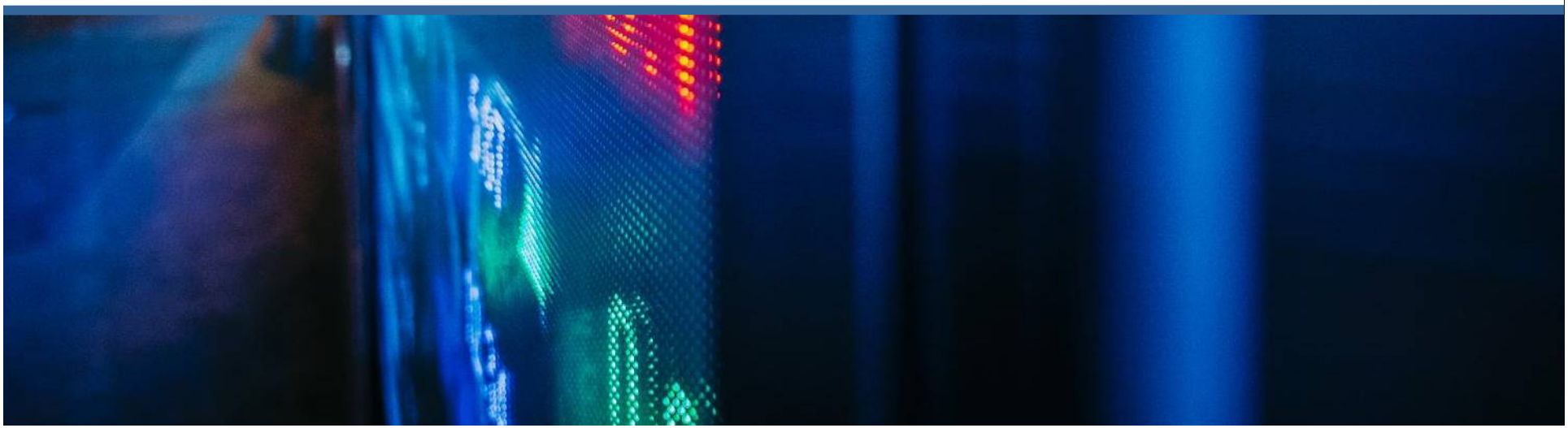
Notice of Proposed Rulemaking Re: Computer-Security Incident Notification

- Proposed rule would require that regulators be informed of any "notification incident" within 36 hours – the shortest prescribed timeframe of any cyber incident notification obligation in the country
- Regulators stated their intent for "notification incident" to include a narrow category of events, but the definition could be read more broadly
- Comment letter submitted on behalf of BPI, SIFMA, ABA, and IIB has proposed changes including:
  - Narrowing the events that would trigger notification; and
  - Clarifying when the 36-hour "clock" starts running

Executive Order on Improving the Nation's Cybersecurity

- On May 12, 2021, President Biden issued an Executive Order on Improving the Nation's Cybersecurity
- The Order requires enhancements to cybersecurity standards and practices throughout federal government
- Some provisions apply to private companies that are government contractors
- The Order calls on the entire private sector to follow its lead
- Enhancements it requires can be expected to become benchmark practices throughout the private sector

4 Consumer Protection



Renewed Push for Consumer Protection

1. Unfair, deceptive, or abusive acts or practices (UDAAPs)
2. Fair and responsible banking
3. Credit reporting data
4. CRA
5. State regulation

ESG in Court

- Without a strong regulatory framework, activist are creating ESG policy through litigation using a variety of inventive legal theories that continue to evolve
  - Truthfulness Cases

Deceptive Green Labeling
Keurig Recyclability Case

→

Failure to Disclose
Mars Child Labor Case

→

ESG v. Company Performance
Tyson Humane Animal Treatment Policy Case

    - Omissions generally not actionable unless matters central to the function and purpose of the product
    - Distinction between "aspiration" and "statement of fact"
  - Company Performance Cases

GHGs as a "Public Nuisance"
AEP v. Connecticut

→

Products Liability for Fossil Fuels
Oil Majors Litigation

→

What comes next?
Supply chain? Breach of Fiduciary Duties? Environmental Justice?

- Cases have had limited success establishing new requirements or exacting damages
- But, they address high-profile issues that implicate company reputation and goodwill

ESG in Court – *ExxonMobil Cases*

- ExxonMobil has been at the center of some of the most consequential ESG litigation
  - Claims implicate ESG reports, GHG pledges, climate policy, allegations of "greenwashing"
  - Main Allegation: Exxon used one "proxy cost" for GHGs to value assets in public documents and a different proxy cost internally

Attorney General Initiatives

- Brought by Connecticut, New York, Massachusetts, and Minnesota
- New York securities claims under state's Martin Act failed in court in major victory for Exxon
- Claims by other states involve Unfair Practices, Fraud, Consumer Protection, and Breach of Fiduciary Duties

Shareholder Actions

- Brought by individuals and institutional investors
- Claim Exxon violated Securities and Exchange Act and defrauded investors with inaccurate financial information
- Growing class action proceeding in federal court in Texas despite major effort to dismiss claims based on First Amendment and political speech grounds

What You Should Be Doing Now

- SEC and ESG Integration
  - Responsible departments must communicate and work together
  - ESG statements must be reviewed for “materiality,” possible inclusion in financial disclosures
  - New SEC guidance and rules mean integration is only a matter of time
  - Companies that are already operating as one unit will have an advantage
- Manage liability with Climate and ESG guardrails
  - Climate and ESG positions must undergo legal review
  - Necessary to understand and manage implications of aspirational v. factual assertions
  - Formalize procedures for producing and vetting climate and ESG positions and materials
  - Biggest exposure from seemingly contradictory statements, whether internal or public

Where Are We Headed?

- Regulatory risks will come from all corners of the government, not just traditional financial and environmental regulators
  - Biden administration emphasizes whole-of-government approach to climate, racial justice
- Voluntary reporting organizations are merging, positioning to set standard adopted by regulators, but second wave ESG standards are not far off
  - Social and environmental responsibility concepts, and governance structures needed to implement them, will expand
  - Standards pushed by activists, standard-setting organizations and first-movers in industry will continue to outpace government and set new baseline
- Evolving space requires broad, cross-cutting oversight
- High-level ESG management will allow some companies to set the terms of the debate for what ESG will require

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