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Increased Shareholder Activism at Banking Organizations?

Posted by Steve Wolosky, Andrew Freedman, and Ron Berenblatt, Olshan Frome Wolosky LLP, on Saturday, July 13, 2019

Editor's note: Steve Wolosky, Andrew Freedman, and Ron Berenblat are partners at Olshan Frome Wolosky LLP. This post is based on their Olshan memorandum. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here); Dancing with Activists by Lucian Bebchuk, Alon Brav, Wei Jiang, and Thomas Keusch (discussed on the Forum here); and Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System by Leo E. Strine, Jr. (discussed on the Forum here).

On April 23, 2019, the Federal Reserve Board (the "FRB") invited public comment on a proposal to revise the FRB's rules for determining whether an entity controls a bank or bank holding company ("banking organization") for purposes of the Bank Holding Company Act of 1956, as amended (the "Act"). The proposal is intended to clarify, in particular, how the FRB decides whether an entity exercises a "controlling influence" over a banking organization. If an entity has a controlling influence and, thus, control over a banking organization, the entity generally becomes subject to regulation as a bank holding company under the Act. The FRB's current framework for making control determinations is complex and, as the FRB acknowledges in its opening statements on the proposal, "difficult for the public to understand and apply with confidence."

As a result of the current uncertainty surrounding whether an investment in and/or engagement with a banking organization would constitute control under the FRB's current framework and the consequences of becoming subject to the burdens imposed by bank holding company regulation, our shareholder activist clients have generally shied away from campaigns at banking organizations. The prospect of being regulated as a bank holding company and subject to FRB examination and supervision just for seeking to catalyze positive change at a bank could be unnerving to an activist to say the least.

Under the existing control framework there is a presumption that an investor does not control a banking organization as long as its percentage ownership of the voting securities does not exceed 4.99%. However, once an investor exceeds this 4.99% threshold, it could find itself in the crosshairs of an FRB inquiry where the investor will have the burden of demonstrating to the FRB that it does not control the banking organization. The FRB will often require the investor to prove that it does not control the banking organization by signing a set of "passivity commitments," which could include prohibiting the investor from soliciting proxies in opposition to management, having more than one representative on the board or otherwise attempting to exert controlling

influence over the banking organization. As a result, banking organizations are frequently passed over by shareholder activists as potential targets.

Existing "Control" Definition and FRB Interpretation

Under the Act, an investor has "control" over a banking organization if:

- The investor directly or indirectly owns, controls or has the power to vote 25% or more of any class of voting securities of the banking organization;
- The investor controls in any manner the election of a majority of the directors of the banking organization; or
- The FRB determines, after notice and opportunity for hearing, that the investor directly or indirectly exercises a **controlling influence** over the management or policies of the banking organization; however, for purposes of this third prong, there is a presumption of noncontrol if an investor directly or indirectly owns, controls or has the power to vote less than 5% of any class of voting securities of the banking organization.

The first two prongs of the control test are clear and leave little room for interpretation. However, the third prong, which has historically required the FRB to make a determination as to whether a "controlling influence" exists based on the facts and circumstances of each particular situation, has presented elements of complexity and uncertainty to the control analysis. Although the FRB has issued public and private interpretations on what constitutes a controlling influence, the FRB admits that its control regime "has become one of the more ad hoc and complicated areas of the [FRB's] regulatory administration" that has evolved over time through a "Delphic and hermetic process."

Proposed Sliding-Scale Control Framework

In order to address the general uncertainty and guesswork as to whether a proposed investment in a banking organization would be controlling, the FRB has proposed a comprehensive framework of presumptions that it would apply when making its control determinations. The proposal would expand the number of presumptions historically used by the FRB in making its control determinations and these presumptions would be codified in Regulation Y (a substantially identical set of presumptions would apply to savings and loan holding companies under Regulation LL). By enhancing the "predictability, simplicity and transparency" of the FRB's control analysis, the framework is intended to lay out "a broadly applicable and uniform set of rules to address the large majority of control fact patterns." The FRB requested public comment on the framework by July 15, 2019.

The proposal is structured as a tiered framework divided into the following four ranges of percentage ownership of voting securities of the banking organization:

Percentage of Voting Securities Controlled By Investor			
Less than 5%	5% – 9.99%	10% – 14.99%	15% – 24.99%

Under the proposal, the percentage of voting securities owned by the investor is the "core consideration" in the control analysis—with a strong presumption of noncontrol at the less-than-5% threshold and a separate presumption of noncontrol at the less-than-10% threshold (subject to additional conditions). Under the proposal, depending on the voting ownership tier, a presumption of control will exist based on the levels of one or more relationships or other factors applicable to the tier that the FRB has historically viewed as allowing an investor to have a controlling influence over a banking organization, including the following:

- Rights to representation on the board of the banking organization;
- Service of director representatives as chair of the board and on committees of the board of the banking organization;
- Use of proxy solicitations with respect to the banking organization;
- Covenants or other agreements that have the effect of influencing or restricting management or operational decisions of the banking organization;
- Management, employee or director interlocks between the investor and the banking organization;
- Scope of business relationships between the investor and the banking organization; and
- Size of total equity investment in the banking organization.

The framework essentially works as a sliding-scale matrix—as an investor's voting ownership percentage in the banking organization increases, the relationships and other factors listed above through which the investor has the ability to influence control generally need to decrease in order to avoid a control presumption. The FRB released a chart illustrating the different combinations of these relationships and other factors for each voting ownership tier that would result in a presumption of control or noncontrol. The chart is reprinted below.

Summary of Tiered Presumptions
(Presumption triggered if any relationship exceeds the amount on the table)

	Less than 5% voting	**5-9.99% voting**	**10-14.99% voting**	**15-24.99% voting**
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses

		revenues or expenses		
Business Terms	N/A	N/A	Market Terms	Market Terms
Officer/Employee Interlocks	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	Less than one third	Less than one third	Less than one third	Less than one quarter

We discuss in further detail below the aforementioned relationships and other factors that we believe would be most relevant to shareholder activists. It is important to keep in mind the FRB's guidance that "absent unusual circumstances," if a presumption under the proposed framework is not triggered, the FRB "would not expect to find" that an investor controls a banking organization. In actual practice, however, the question of whether any specific activities commonly associated with shareholder activism, on their own or taken as a whole, would be considered by the FRB to be "unusual" and thereby cause it to find that an indicia of control exists despite none of the proposed presumptions being triggered will be key for activists to understand where they actually stand under the new regime.

Director Representatives

The proposal would expand the ability of shareholder activists to gain representation on the boards of banking organizations. In 2008, the FRB issued an important policy statement updating its guidance on the control definition in the Act that began to give practitioners more direction on how to advise shareholder activists in this area. Citing this policy statement, the FRB states in the proposal that it has generally taken the position that an investor owning at least 10% of the voting securities of a banking organization (and who has presumably signed a passivity commitment) should be able to have a maximum of one director representative on the board without creating control. Moreover, absent other indicia of control, the FRB would not consider a second director representative as creating a controlling influence when two director representatives would be proportionate to the investor's total voting interest in the banking organization (but does not exceed 25% of the board) and when there is another larger shareholder that controls the banking organization.

Under the proposal, an investor who owns 5% or more of the voting securities of a banking organization would only be presumed to control the banking organization if the investor controlled 25% or more of the board. Thus, the proposal could under certain circumstances allow an investor with less than 25% voting power to have greater than "proportional" director representation without creating a presumption of control.

The proposal would not create a control presumption based on the level of director representation of an investor owning less than 5% of the voting securities. As a result, under the proposal, a less-than-5% investor would generally only be deemed to control the banking organization due to its level of director representation if it controlled a majority of the directors, thereby triggering the bright-line second prong of the statutory definition of control. In the case of boards comprising an even number of directors, we believe the FRB would also view an investor with control over exactly 50% of the board (e.g., the investor has 5 director representatives on a 10-member board) as having a controlling influence by virtue of effectively having a veto right over board decisions requiring a majority vote.

Of particular relevance to shareholder activists, the proposal confirms the FRB's view that a "director representative" of an investor would include any director who was "nominated or proposed" by the investor to serve on the board of the banking organization. As a result, even an individual who is completely independent of and unaffiliated with an activist who is appointed or elected to the board after being formally nominated for election as a director by the activist would be considered a director representative. With respect to independent and unaffiliated designees of an activist appointed to the board pursuant to a settlement agreement, we believe the FRB would likely also view such individuals to be director representatives under the proposal. However, it is not uncommon for an activist to merely suggest to a company that it take a look at one or more potential independent director candidates who could be good additions to the board. It is not as clear whether such an individual, if appointed, would be considered a director representative under the proposal and we anticipate this ambiguity will surface during the comment process. A non-voting board observer would not be a director representative.

Service as Board Chair and on Committees

Recognizing that director representatives could exert additional influence over the policies or operations of the banking organization by virtue of holding the position of chair of the board or serving on certain committees of the board, the proposal includes presumptions of control addressing these additional board functions.

The FRB views the chair of the board as having a position of "heightened influence" with powers that could exceed those possessed by the other directors. As a result, under the proposal, a presumption of control would exist if an investor owning 15% or more of the voting securities has a director representative who serves as chair of the board. In addition, the FRB has previously raised concerns when director representatives have the power to influence decisions of the banking organization by serving on committees of the board that have a mandate to take certain action without approval of the full board. Board committees that could wield such powers include the audit committee, compensation committee and executive committee. As a result, under the proposal, there would also be a presumption of control if an investor owning 10% or more of the voting securities has director representatives that comprise more than 25% of any committee of the board that has the power to bind the banking organization without the need for additional

board approval. According to the FRB, the foregoing presumptions would be “modestly more permissive” than its historic position in this area.

If the proposal is approved, shareholder activists would need to be aware of these presumptions, particularly with respect to any activist situation involving board representation. It is relatively uncommon for a director representative of a shareholder activist who obtains minority board representation to become chair of the board. However, settlement agreements granting board representation to the activist typically also cover board committee assignments and may even provide for the formation of a new committee, such as a special committee to review strategic alternatives or to oversee a sale process, with a mandate to take certain actions that bind the company. Shareholder activists would need to take into consideration the chair and committee service presumptions when negotiating their settlement agreements with banking organizations.

Election Contests

The FRB has acknowledged that a noncontrolling minority investor may communicate with management of a banking organization and advocate for policy and operational changes. While such discussions and advocacy alone “are not the type of controlling influence targeted by the [Act],” the FRB has in the past raised concerns with shareholders soliciting proxies to elect a slate of director candidates in opposition to the board recommended slate. Such a solicitation is viewed by the FRB as a way for an investor to “influence the existing members of the board of directors, even those members of the board of directors that the investor has not targeted for removal” and therefore a contested election can have a significant impact on the management and policies of the banking organization. Indeed, as a result, the FRB has in the past raised controlling influence concerns even when an investor owns less than 10% of the voting securities and engages in a proxy solicitation to elect directors of a banking organization (requiring that some enter into passivity commitments, as noted above).

The proposal would create a presumption of control if an investor owning 10%-24.99% of the voting securities solicits proxies to elect a director slate that equals or exceeds 25% of the board. This proposal is designed to align the presumption for proxy solicitations to elect directors with the proposed presumption discussed above relating to the total number of director representatives an investor could have on a board. As a result, under the proposal, an investor would have the ability to engage in a proxy solicitation to elect directors without creating a presumption of control as long as the number of its director candidates (together with any other director representatives the investor may already have on the board) is not greater than the maximum number of directors the investor may have on the board under the director representation presumption. The FRB acknowledges that this narrower form of the current presumption “would allow investors somewhat greater ability to engage in standard shareholder activities without raising significant control concerns.”

Contractual Rights

The FRB has historically considered contractual provisions that provide an investor with rights that have the effect of influencing or restricting the policies, management or operations of a banking organization as a cause for control concerns. The FRB is especially concerned when investors have veto rights or effective veto rights over such policies, management or operations and when such rights are combined with material equity ownership in the banking organization.

Such rights and material ownership together have the potential to be used to exert influence over the banking organization.

The proposal would generally maintain the FRB's presumption of control if an investor owning 5% or more of the voting securities has "any contractual right that significantly restricts the discretion of the [banking organization] over major operational or policy decisions." However, the proposal suggests that there would be no presumption of control for an investor owning less than 5% of the voting securities, even if the investor has such contractual rights.

The proposal includes the addition of a new term, "limiting contractual right," that is defined to mean a contractual right that would allow the investor to "restrict significantly, directly or indirectly, the discretion of the [banking organization], including its senior management officials and directors, over operational and policy decisions." The definition would also include a list of nonexclusive examples of what would and would not constitute a "limiting contractual right."

In the proposal, the FRB discusses how investors often obtain these limiting contractual rights under agreements with banking organizations pursuant to which investors acquire their voting securities (i.e., stock purchase agreements) and pursuant to other contractual arrangements such as investment agreements and debt relationships. However, shareholder activists should be cognizant that such limiting contractual rights, particularly veto rights that could override a policy or operational decision of the board, could also appear in settlement agreements with banking organizations in the context of an activist campaign. A settlement agreement would create a presumption of control if it contains one or more covenants that fall under the nonexclusive list of examples of what would constitute a "limiting contractual right." In our experience, covenants that we see in settlement agreements that would fall under the list include rights that allow the activist to approve, veto or otherwise exert significant influence over decisions relating to:

- entering into new lines of business;
- discontinuing existing lines of business;
- hiring or terminating senior management;
- modifying employee compensation;
- entering into M&A transactions;
- paying dividends;
- engaging in public offerings;
- making certain charter/bylaw amendments; and
- selecting investment bankers and investment advisors.

Areas Where FRB Not Proposing Presumption of Control

The proposal also discusses other areas where the FRB has historically raised concerns of a controlling influence but does not propose a presumption of control within the framework. The following areas where a presumption of control is not being proposed that may be of interest to shareholder activists are discussed below.

Proxy Solicitations on *Any* Issue

In the past, the FRB has raised control concerns when an investor owning 10% or more of the voting securities conducts a proxy solicitation against a banking organization involving *any* issue. The FRB is not proposing a presumption of control under these circumstances. As a result, the FRB states that the proposal "would provide a noncontrolling investor greater latitude to exercise its shareholder rights and engage with the target company and other shareholders on certain issues."

Threats to Dispose Securities

Historically, the FRB has also raised control concerns when an investor owning 10% or more of the voting securities threatens the banking organization that it will dispose all or large blocks of its securities if the banking organization refuses to take certain action. The FRB is not proposing a presumption of control under these circumstances recognizing that "an investor who is unhappy or disagrees with the business decisions of the [banking organization] in which it invests should be able to exit its investment, and the possibility of investor exit imposes important discipline on management."

Other Presumptions and New Presumptions of Control

The proposal also includes other presumptions of control, several of which are already covered by Regulation Y, new presumptions of control, ancillary rules and other standards (including when an investor controls securities through options, warrants and other derivatives) that are outside the scope of this client alert. However, it is important to note that under the proposal, a presumption of noncontrol would exist if an investor owns less than 10% of the voting securities (up from less than 5% under the current regime) of the banking organization and no other proposed presumptions of control are present, representing a "modest" expansion of the existing presumption. This is particularly significant for shareholder activists in the 5%-9.99% ownership range as, in practice, investors in this category have in recent years been required to enter into full blown passivity commitments even though the FRB's "historical" approach focused on 10%-or-more investors. Basically, the proposal clarifies and confirms that less-than-10% investors generally should be safe so long as they avoid crossing a few bright-line control tests.

Conclusion

Until now, the FRB's case-by-case approach to determining questions of control based on specific facts and circumstances and the complexity and lack of transparency of its control determinations have contributed to a general reluctance by shareholder activists to target banking organizations. We believe simplifying the control framework and establishing a broad set of rules that specifically cover highly relevant areas for shareholder activists, such as ownership thresholds, board representation and election contests, would introduce an important level of predictability to the control analysis that could loosen things up for activists in the banking sector. The proposal could also make the banking sector much more attractive to shareholder activists as a result of the more permissive director representation and election contest standards. Fearing the possibility that the sector could become the next hotbed for activists, we would not be surprised to see banking organizations begin to adopt various anti-takeover measures.

If the proposal is approved, shareholder activists should continue to proceed with caution when accumulating a position in a banking organization. Even though the FRB states that “it would not expect” to find that an investor controls a banking organization unless a presumption of control is triggered under the new framework, the FRB would still have the authority to conduct a controlling influence inquiry based on the particular facts and circumstances of each case. The FRB could also have separate safety and soundness concerns arising from the investment and/or other relationships with the banking organization. In addition, applicable state banking regulations may invoke separate ownership limitations and other restrictions that could impact a shareholder activist’s acquisition program and investment strategy.