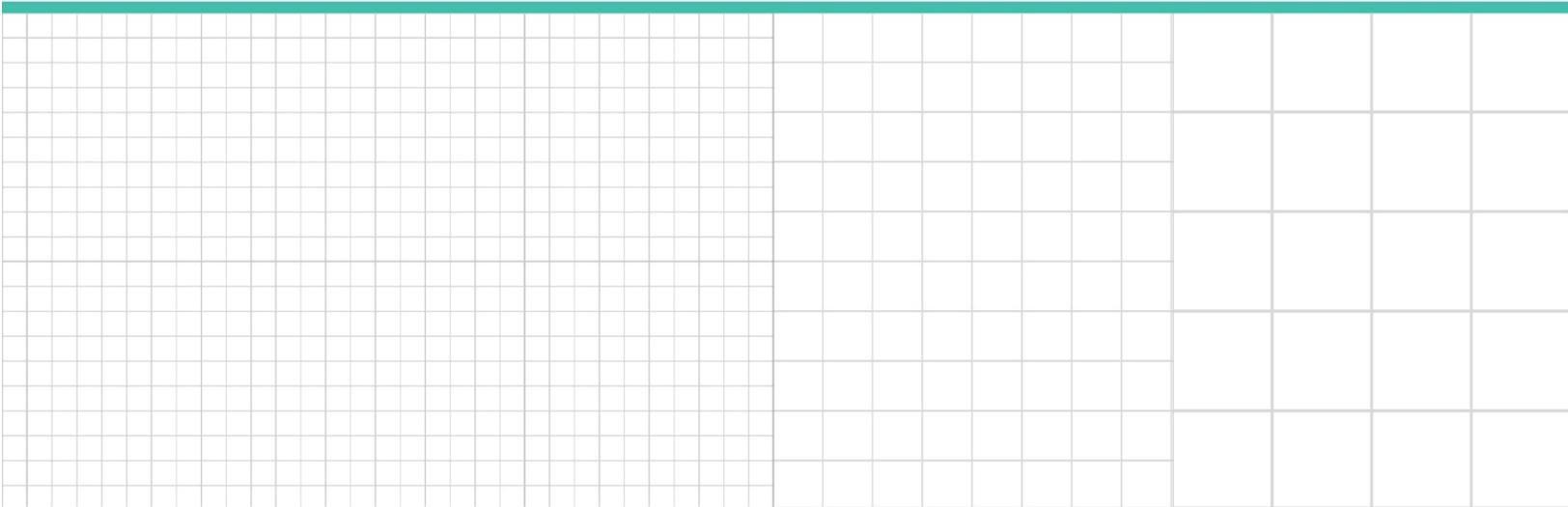


**Professional Perspective**

# **What the FRB Non-Control Proposal Means for Activist Investment in Banks**

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# What the FRB Non-Control Proposal Means for Activist Investment in Banks

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On April 23, 2019, the Federal Reserve Board proposed a new framework for determining when an investor has “control” under the Bank Holding Company Act. “Control” is an important concept under the BHC Act because entities controlled by bank holding companies, as well as entities controlling banking institutions, become subject to strict regulation, oversight, and examination by the FRB. Many in the industry hope the FRB’s proposal will facilitate investments by banks in financial technology companies. While there is a natural affinity between banking and fintech, many fintech companies have been reluctant to subject themselves to the intensity of FRB oversight.

At the same time, the FRB proposal would allow nonbank entities—including shareholder activists—to make larger investments in banking institutions, and to have greater interlocks and contractual relationships with them, without the investors having to worry about subjecting themselves to the BHC Act. While shareholder activists have occasionally invested in banks and bank holding companies, in particular community banks, historically the FRB’s application of the BHC Act, and its requirements (including passivity commitments) for investors to avoid being deemed to “control” a banking institution, have limited the investment size (which typically has remained below a 10% voting interest) and other indicia of control activists take relative to other less regulated sectors.

The FRB’s proposal would increase transparency, but not without cost: having clear guardrails may make some drivers less cautious. By creating a matrix of permissible and non-permissible activities at increasing levels of voting equity ownership, the FRB’s proposed changes seem likely to increase the ability of shareholder activists to exert influence over banks and bank holding companies and may lead to greater activist interest in the banking sector. After first discussing the additional clarity and flexibility the FRB proposal provides to shareholder activists, we then suggest some possible bank board and management responses.

## Stake Building

The FRB proposal, if adopted as currently proposed, would enable an activist investor to acquire a larger interest in a banking institution without being deemed to control. Under the BHC Act, a voting stake of less than 5% in a bank or bank holding company is presumed by the FRB to be non-controlling. The proposal would increase this threshold to 10%—a change the FRB said would “modestly expand” the existing non-control presumption, although in fact it would double it. Investors find the presumption of non-control beneficial because of the uncertainty over what actions, or combination of actions (such as voting interests and contractual rights), might cross the line into control. Empowering activists to cross the 5% threshold increases their leverage, not only because they (and like-minded investors) will control more votes, but also because we may now see bank activists filing Schedule 13Ds, required after crossing the 5% threshold, which will give them a public platform for their plans and proposals.

The proposal would also provide guidelines for making non-controlling investments above the 10% threshold, subject to additional restrictions on the activities of the investor. The proposal would not affect the existing requirement for a nonbank investor to obtain approval under the Change in Bank Control Act before crossing the 10% voting threshold, or under any analogous state laws. A CIBC Act application, however, does not raise the same approval or ongoing burden requirements as a BHC Act application, and there is no obvious reason activists should not be able readily to obtain CIBC Act approvals.

Though not stated explicitly, the proposal apparently would also no longer require passivity commitments from investors seeking to avoid control after acquiring a larger than 5% voting interest. Moreover, in a departure from current practice, the proposal would not presume control where an investor with 10% or greater voting stake threatens to dispose of large blocks of voting or nonvoting securities in an effort to affect policy and management decisions. These changes are likely to increase the ability of shareholders with 10%+ voting stake to exert influence over the policies and management of a banking institution without being deemed to control it.

## Board Seats and Management Interlocks

In addition to allowing investors to acquire a larger equity interest, the FRB proposal would give investors more flexibility to make changes at the director and senior management levels without being deemed to control a banking institution. Under the existing regime, a material investor could seat more than a single director only if another investor in the bank was a bank holding company (and then it could seat only two). The FRB's proposal would allow an investor with less than 5% voting power to nominate—and to solicit proxies for—up to just under half the directors of a banking holding company.

An investor with between 5% and 24.99% voting stake would be permitted to nominate up to just under a quarter of the board. In addition, although the FRB previously raised concerns about controlling influence if an investor with a 10% or more voting stake solicited proxies on any issue, the proposal would not presume control in this circumstance, giving the investor greater ability to exercise shareholder rights.

These are meaningful changes that are likely to increase the power of activist shareholders. While one can debate how important it is whether an activist has a single director representative or some larger (but still minority) number, in our experience an activist seeking to seat multiple candidates is viewed as a greater threat to a company than one seeking only a single director. Moreover, having multiple activist voices in the boardroom has a real effect on board dynamics. Obviously, in the potential scenario in which a 4.9% shareholder seats, for example, six nominees on a 13-member board, that shareholder can be expected to have more of an impact on the company's direction.

The FRB's proposed matrix would impose limitations on management interlocks, but the FRB acknowledged the limitations would be more liberal than the current regulatory framework. Below a 5% voting stake, under the proposal there would be no limits on senior management interlocks—meaning that, in the hypothetical example above, an activist with a 4.9% voting stake could seat six directors out of 13 and have several employees in senior management positions. Holders with a 5% to 14.99% voting stake would be permitted to have one senior management interlock (e.g., an employee or director of the holder). Above a 15% voting stake, no senior management interlocks would be permissible.

## Total Equity

The proposal would allow a non-controlling investor to acquire a total equity interest of up to one third of the company's total equity, provided that the investor's voting stake remains below 15% (consistent with the current framework). In its proposal, the FRB explained why it views a stockholder's overall equity ownership (rather than merely voting interest) as an important metric of control: owners with large equity stakes have strong incentives to influence the company, they absorb losses if the company struggles (and profit if it succeeds), and companies are likely to listen to large holders to maintain stability, enhance their ability to raise equity capital, and prevent negative market signals from sell-offs by large holders.

Interestingly, while an investor's equity position includes non-voting equity (such as preferred stock) and instruments exercisable for or convertible into equity (such as options or warrants), it does not appear to include derivative securities (such as cash-settled total return swaps) that will not be settled in company equity.

## Possible Bank Board/Management Responses

Like other public companies, banks are focused on the interests of their shareholders, and they must address the issues raised by activists. If the control framework is adopted as proposed by the FRB, activist issues may gain greater importance with banks as they lose some of the protections historically provided by the BHC Act. In our experience, companies seeking to address activist issues have a number of tools available to them, including advance planning to evaluate structural vulnerabilities, anticipate likely activist themes, and frankly assess whether foreseeable activist proposals are feasible and would add value. Equally important, companies may wish to consider whether they have focused appropriately on maintaining an ongoing, rigorous program of meaningful shareholder engagement, irrespective of any particular activist intervention. Banks will also have the opportunity to weigh in on the FRB's proposal, including regarding the issues raised above: the proposal is subject to public comment until 60 days after its publication in the Federal Register.