Federal Reserve Relaxation of Restrictions on Activist Bank Investors

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Activist investors have existed almost as long as corporations themselves, and their agendas are as varied as their tactics. Typically cloaking themselves in the noble cause of “shareholder rights,” activists are much more often motivated by the more basic vices of egotism and greed. Their strategy is usually to impose substantial leverage and chaos on the management of a corporation in a way that allows them to use the resulting governing instability to promote and achieve their own interests.

Because of activist shareholders’ destabilizing influence, and their tendency to exert control in a covert way, federal banking regulators have traditionally given
activists a very short leash. As a result, financial institutions historically have been subjected to fewer demands and other pressures from shareholder activists than have companies in less regulated industries. Unfortunately, this appears to be changing, in particular with respect to community banks and savings institutions and their holding companies.

A significant factor in activist investors’ current interest in banking targets has been, and will continue to be, the recent relaxation of the Federal Reserve Board’s rules under the Bank Holding Company Act (the BHC Act) defining the factors under which companies are deemed to “control” banks and bank holding companies. Prior to 2020, the Federal Reserve’s “control” regulations, interpretations, and policies placed important restrictions on the ability of investing companies holding more than 5% of a class of voting securities of a banking company to engage in shareholder activism. The limitations included a requirement that such investing companies enter into “passivity commitments” that, among other things, prohibited them from (i) having more than one representative on the banking company’s board of directors, (ii) soliciting proxies on any matter in opposition to the recommendation of the target company’s board of directors, and (iii) proposing a slate of directors in opposition to a slate proposed by the incumbent board of the company.

Effective in September 2020, the Federal Reserve adopted a comprehensive regulatory control framework (the 2020 Rule) for determining when an investing company has control of a bank or bank holding company under the BHC Act. According to the Federal Reserve, the 2020 Rule was intended to clarify the standards for control that were often criticized as being too ambiguous. However, by clarifying these standards, the 2020 Rule revised certain presumptions in a way that will allow activist investors to make larger investments in, and exert greater influence on, banking companies without becoming subject to Federal Reserve oversight. The most important of these activist-friendly revisions are the following (addressed separately in the following paragraphs):

- The increase, from 5% to 10%, in the level of ownership of voting stock at which an investing company will be presumed not to control a banking company.
- The elimination of the Federal Reserve’s “passivity commitments,” which the Federal Reserve previously applied to most nonindividual investors holding 5% or more of a class of voting securities of a banking company.
- The greater number of permissible director representatives of investors and their expanded role.
- The relaxation or removal of restrictions on activist investors engaging in proxy contests.

**Presumption of Noncontrol for Less-than-10% Investments**

Under the BHC Act, a voting stake of less than 5% in a banking company is presumed to be noncontrolling. The 2020 Rule increases the threshold for the noncontrol presumption to 10% — a change that is likely to allow activist investors to gain additional leverage over banking companies, especially when (as is often the case)
they clandestinely coordinate actions with other investors.

The 2020 Rule also provides liberalized guidelines for noncontrolling investments in banking organizations above 10% of a class of voting stock. However, it is expected that most activist investors will choose not to exceed the 10% threshold, in light of the continuing requirement for a nonbank investor to obtain prior approval under the Change in Bank Control Act for the acquisition of 10% or more of a class of voting stock of a banking company.

Elimination of Passivity Commitments

The Federal Reserve historically required passivity commitments from noncontrolling investing companies in banks or bank holding companies with voting interest of 5% or more of any class of voting securities, which commitments — as noted above — significantly restricted such investors’ ability to exercise a controlling influence over the banking organization without the filing of a formal change-in-control application. The Federal Reserve’s release accompanying the 2020 Rule stated that the Federal Reserve does not intend to obtain “the standard-form passivity commitments going forward in the ordinary course.” Furthermore, the Federal Reserve indicated that investors subject to outstanding passivity commitments under the former framework now will (except in unusual circumstances) be able to obtain relief from these commitments.

Investor Representatives on Board of Directors

Previously, a noncontrolling investor with 5% or more of the voting shares of a banking company was typically limited to a single director representative, with few exceptions. As a result of the 2020 Rule, an investing company with 5% or more but less than 25% of the voting shares of a banking company can now have director representatives constituting up to 24.99% of the board of directors. An investing company holding less than 5% of the voting shares of a banking company can now have director representatives constituting up to 49.99% of the board. In addition, the 2020 Rule permits director representatives to have broader roles on the board than in the past. Previously, a director representing a noncontrolling shareholder was not permitted to chair the board or its key committees or to participate at all in committees that have the power to bind the banking company. Under the 2020 Rule, if an investing company holds less than 10% of the voting shares of a banking company, it is free from all of these restrictions.

Proxy Solicitation for Director Election

The Federal Reserve’s prior practice generally did not permit any investor with 5% (if subject to passivity commitments) or 10% or more of any class of voting securities of a banking company to solicit any proxies on any issue in opposition to board recommendations, including director election contests. However, under the 2020 Rule:

- An investing company holding less than 10% of each class of voting securities of a company is not subject to any formal limitation on soliciting proxies for candidates for directors.
An investing company holding between 10% and 24.99% of any class of voting securities is permitted to solicit proxies for its permissible number of director representatives. For example, a company holding 10% or more of a class of voting securities of a banking company could solicit proxies to elect less than 25% of such company’s board members without being presumed to control the banking company.

**Proxy Solicitation for Other Issues**

The Federal Reserve historically has raised a presumption of control if a company with 10% or more of a class of voting securities of a banking company solicits proxies from the shareholders of that company on any issue, and a prohibition on the solicitation of proxies in opposition to recommendations of a company’s board of directors has typically been included in the Federal Reserve’s standard passivity commitments. In a significant liberalization of the Federal Reserve’s prior policy, the 2020 Rule does not include a general presumption of control for a company that solicits proxies for shareholders of a banking company for any issue other than director elections. In the preamble to its proposed rule, the Federal Reserve noted that this policy change “would provide a noncontrolling investor greater latitude to exercise its shareholder rights and engage with the target company and other shareholders on certain issues.”

In summary, the above changes to the Federal Reserve’s regulatory control regime weaken the protections of financial institutions against shareholder raids and hostile takeovers that were historically provided by Federal Reserve policy under the BHC Act. These changes are leading to increased activist interest in the banking sector — particularly in community banking organizations, where an investor can exert influence with a fairly modest investment.

In light of the threat posed by activist investors’ short-term profit interests to a community banking organization’s goals of long-term creation of shareholder value and service to its local community, it is important for non-closely held community banks to consider taking certain defensive steps before activist forces establish a beachhead. The next article in this series examines certain steps that community bank boards and management can take to enunciate their visions for their institutions and to defend those visions through shareholder engagement, careful examination and possible improvement of corporate governance documents, and other corporate actions.

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