ETHICAL boardroom

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Companies in highly regulated industries have historically been subjected to relatively few campaigns and demands from shareholder activists, primarily because any would-be activist seeking the support of its fellow shareholders would face the added challenge of needing to navigate a complex regulatory regime and potentially obtain regulatory approvals.

But as activist investors have grown more sophisticated, they have also become more willing to take on targets in regulated industries, including banks and insurance companies. This was evident in 2019 between the renewed contest that Blue Lion Capital waged at HomeStreet Inc, a Seattle-based community bank, and the rollercoaster of a campaign that played out between Voce Capital Management and Bermuda insurer Argo Group International Holdings Ltd before a settlement was struck. Both proxy contests featured the regulatory defence, where the company leveraged its relationships and familiarity with local regulators to claim that the activists' attempt to elect independent directors constituted a change of 'control' under relevant state regulations, which would mean an activist would have to face onerous filing and disclosure requirements.

Nonetheless, the increased preparedness among seasoned activist investors to weather the challenges posed by the banking and insurance regulatory regimes has coincided with increased M&A activity in these regulated industries. That combination has made activism in regulated industries an option worth considering. When an investor has ample time to plan an activist campaign and has the benefit of top-tier counsel on both shareholder activism law and industry-specific regulatory aspects, the challenges of effecting change at a regulated company can be surmounted.

Companies in regulated industries enjoy added protection from adversarial or hostile tactics largely because certain state statutes (and, in the case of banks, federal statutes) require that a shareholder seeks and receives prior regulatory approval before such a shareholder is presumed to have acquired control of an insurance company or bank. The shrewd investor will understand how to structure a campaign to avoid crossing any 'conclusive' control thresholds and be prepared to engage with regulators to rebut any 'presumption' of control and expose the regulatory defence as symptomatic of a company lacking defences that resonate with shareholders, such as demonstrably sound corporate governance and a healthy track record of value creation.

THE INSURANCE REGULATORY REGIME

The definition of control in most state insurance holding company acts, which are generally based off the model Insurance Company System Regulatory Act adopted by the National Association of Insurance Commissioners, focusses on whether a person owns directly or indirectly 10 per cent or more of an insurer's voting securities. Particularly troublesome for the investor seeking to catalyse changes at an insurer via a meeting of shareholders, is the fact that state insurance holding company acts typically establish the presumption of control if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, 10 per cent or more of the voting securities of any insurer. Compounding the issue is that there is a lack of clarity on how an investor would be able to conduct a proxy solicitation at an insurance company in favour of a shareholder proposal or the election of shareholder-nominated candidates for director without receiving the prior regulatory approval of insurance regulators to be a control person.

Typically, a person anticipating treatment as a 'control person' of an insurer would file a Form A application, seeking the approval of state insurance regulators to acquire control at an insurer. Because the Form A application is generally used in the mergers and acquisition context, the application requires substantial disclosure, chiefly focussed on evaluating the backgrounds and future plans of the controlling persons of the would-be control person in respect to the insurer being targeted.

Regulators generally consider a Form A filing – which may also include a public hearing in approximately 50 per cent of states – over a period of months before reaching a determination because they are tasked with deciding whether the applicant and its principals are fit and proper persons to manage the targeted insurer.

If a Form A application is approved, the applicant would then be subject to certain limited compliance and disclosure requirements related to the investment going forward. Therefore, the filing of a Form A poses significant timing and disclosure obstacles for any investor seeking to run a proxy or consent solicitation at an insurance company. And in practice, the lengthy, probing and expensive nature of the Form A process will be a non-starter for the vast majority of activists.

Fortunately, state insurance regulators afford shareholders the opportunity to rebut the presumption of control through a more abbreviated process. The rebuttal process usually takes the form of filing a 'disclaimer of control' in each state where the insurer is domiciled. Though some states may use different terminology for this rebuttal filing, the requirements tend to be quite similar.

Generally, the persons hoping to rebut the presumption of control will provide background about themselves and their investment history and provide facts that demonstrate that the proposed investment and future plans with respect to an insurer are passive and/or will not result in control per se, that is, the ability to direct the management, policies or affairs of the insurer.

While there is limited precedent for an investor using disclaimer of control policies to receive unqualified regulatory approval to conduct a proxy solicitation, the temporary and limited nature of proxy voting at a meeting of shareholders aligns with the notion that there would be no meaningful or lasting ability for the soliciting shareholder to direct the management, policies or affairs of the insurer because the vote of the requisite number of shareholders, as opposed to the action or decision of the soliciting shareholder alone, would decide all such matters.

The disclaimer route still adds a challenging variable to an activism campaign, that is of being uncertain when or if regulators will approve a rebuttal of control. This challenged can be amplified when an insurer may be considered domiciled in multiple jurisdictions. For example, in the Argo

Group campaign, the activist found it necessary to lodge rebuttals in five states.

There are variances among the insurance holding company acts of different states, and the regulators charged with making a determination on a disclaimer of control will not necessarily find the disposition or thinking of regulators in another state compelling or even relevant. Therefore, when multiple jurisdictions are implicated, greater resources will be necessary to ensure that the shareholder is pleading the facts for rebutting control in each jurisdiction in a fashion that fully and promptly addresses the questions and concerns of each jurisdiction's regulators.

Liaising with the regulators is prudent at each major step of an insurance activism campaign as any new public messaging or change of tact should be previewed to the regulators to minimise the risk of the regulators changing their determination of non-control in light of new developments.

THE BANK REGULATORY REGIME

The bank regulatory regime consists of federal and state banking laws prohibiting the acquisition of control of certain banking organisations. Under the federal Bank Holding Company Act (BHCA), for example, a party is deemed to control a banking organisation if it '(i) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the other company; (ii) controls in any manner the election of a majority of the directors or trustees of the other company; or (iii) directly or indirectly exercises a controlling influence over the management or policies of the other company'.

It is important to note, in the context of activism, that holding the power to vote shares by virtue of a typical one-time, revocable proxy would generally not trigger the second prong. However, the third prong provides the Federal Reserve Board with the power to find control based on facts and circumstances even where the more objective indicia of control are absent.

Notably, there are marked similarities between the insurance regulatory and banking regulatory control regimes, with bank investors possessing 10 per cent or more but less than 25 per cent of a class of voting stock of a banking organisation having the ability to rebut control. More importantly for activists, however, prior to 2020, a bank investor seeking to avoid being deemed to control the target typically could only seek one board representative, or at most two, even where the investor held less than 10 per cent of the target's voting stock. In theory, such restrictions did not apply to the investor nominating, and soliciting proxies in support of, independent board candidates. But, in practice, noncontrolling investors were prevented from nominating an opposition slate unless it would represent a minority of the board, even if all of the candidates were independent of the investor.

A finding of control would make an investor in a bank holding company (or savings and loan holding company) subject to extensive regulation and supervision by the Federal Reserve Board - something few investors are able or willing to abide. On 30 January 2020, however, the Federal Reserve Board relaxed its regulations under the BHCA and Home Owners' Loan Act (HOLA) as they pertain to noncontrolling investments in banking organisations. Such changes both (i) substantially reduce the likelihood than an investment of 10 per cent or more (but less than 25 per cent) of a class of voting stock would trigger a presumption of control, and (ii) provide significantly greater latitude to investors with interests below 10 per cent.

In regard to the latter, the changes allow noncontrolling investors holding less than 10 per cent of any class of a banking organisation's voting stock to solicit proxies to replace up to the target's entire board. Moreover, such an investor may now seek multiple board representatives, so long as they would constitute less than 25 per cent of the target's board. Investors with less than five per cent of any class of the target's voting stock are permitted to seek even greater board representation, so long as such representative would not constitute a majority of the target's board.

But, while the regulations implementing the control rules under the BHCA and HOLA were amended last year, no changes were made to the regulations implementing a third relevant federal statute – the Change in Bank Control Act (CBCA). Under the CBCA, a bank investor will be presumed to control a bank if the investor's interest constitutes 10 per cent or more of any class of the target's voting stock and either (i) the target has registered securities under section 12 of the Securities Exchange Act of 1934 or (ii) no other person holds a greater percentage of the same class of voting stock. As under the BHCA and HOLA, control under the CBCA becomes conclusive if the investor's interest equals or exceeds 25 per cent of any class of the target's voting stock. An investor that is presumed to control a banking organisation under the CBCA would need to rebut control, which would typically involve making a significant regulatory filing and agreeing to certain restrictive 'passivity commitments' that would, among other things, preclude activism.

Accordingly, unless and until the control rules under the CBCA are amended similarly to those under the BHCA and HOLA, bank investors seeking to engage in activism must keep their investments below 10 per cent of any class of the target's voting stock. But, as discussed above in the context of the BHCA, provided certain criteria are satisfied, the power to vote shares by virtue of a proxy would not cause an investor to cross either the presumptive or conclusive control thresholds under the CBCA.

While the aforementioned changes to federal regulation are likely to make the prospect of investing in banking organisations more appealing to activist investors, we caution that any state banking law regime applicable to a potential target must also be carefully considered, as they are likely to contain more stringent ownership limitations and restrictions on active investment tactics.

Not unlike the insurance regulatory regime, a state bank regulatory analysis will turn on the circumstances and facts relating to amount of stock ownership, the number and independence of any director nominees, any business relationships with the state-chartered banking organisation and the nature of future plans with respect to the target's business. Of the greatest concern to the would-be activist investor seeking to conduct a proxy solicitation at a state-chartered banking organisation should be whether state banking regulations will limit the ability of an investor to hold proxies above a certain threshold (e.g. 25 per cent or more of a class of voting stock) without being deemed to be seeking to acquire control.

In many cases, there may be no clear answer in the relevant statute or regulation, so hiring counsel with relevant experience and the ability to successfully advocate with the relevant state banking agency will often be crucial. Failing to convince an applicable state banking agency that the investor's plans do not amount to an attempt to acquire control would require the investor to go through a process similar to the Form A filing discussed in the insurance company context.

CONDUCTING A CAMPAIGN AT A REGULATED COMPANY

Due to the complexity and uncertainty posed by investing in heavily regulated companies, an activism campaign at an insurer or banking organisation should begin with a regulatory analysis to determine the extent and nature of control issues that may arise. Any regulatory analysis involving a banking organisation or insurance holding company will turn on the extent of stock owned as well as the totality of circumstances and facts of the investment and plans for effecting change at the regulated company. While this calls for added preparation and puts an emphasis on the quality of the advisory team you assemble, this in no way means that activism in the regulated space is impossible or any less ripe a forum for value creation.

Companies who have employed the regulatory defence have irked non-activist investors and institutions because the lobbying of regulators can overshadow the topics of performance and corporate governance or even take away these investors' right to vote on the proposals and nominees put forward by an activist investor. The savvy activist investor will be able to explain the regulatory dimension of a campaign succinctly and expose a company's insistent lobbying of regulators as suppressive of shareholder rights. Positively, regulators are quickly becoming more familiar with the ins and outs of proxy solicitation contests and have largely shown a willingness to understand activist investors' arguments for rebutting determinations of control.

Between the relaxation of certain regulatory schemes and the measured successes in recent years by activists, such as Carl Icahn, John Paulson and Voce Capital Management, the barriers to activism in regulated industries appear to be weakening. And we maintain that insurers and banking organisations can pose viable and lucrative opportunities for activist investors when their campaigns feature well-crafted and researched plans for value creation, a compelling message for shareholders and the assistance of an experienced team of advisors.

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