REPRINT

SHAREHOLDER ACTIVISM IN THE US BANKING INDUSTRY

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HOT TOPIC

SHAREHOLDER ACTIVISM IN THE US BANKING INDUSTRY

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Tim Main is a senior managing director in Evercore's corporate advisory business, focused on banking and specialty finance institutions. Prior to joining Evercore in 2011, Mr Main spent 23 years at JPMorgan Chase and was most recently Head of North American FIG and Co-Head of Global FIG. Prior to running FIG, he ran JPMorgan's Equity Capital Markets group. At Evercore, Mr Main has worked on several significant advisory assignments in the depository/specialty finance sector, including advising M&T on the acquisition of Hudson City and multiple transactions by Ally Financial.

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Jason Frankl is a senior managing director and leads FTI Consulting's Activism and M&A Solutions practice. His practice includes working with companies that are the subject of shareholder activism and/or hostile M&A activity where he develops and implements strategies that are designed to maximise shareholder value. Most recently, Mr Frankl and his colleagues supported Allergan in its successful defence involving Pershing Square and Valeant Pharmaceuticals, and Perrigo in its successful defence involving Mylan's hostile takeover bid. Prior to joining FTI Consulting in 2004, Mr Frankl was counsel to the NASDAQ Stock Market where he drafted and interpreted NASDAQ's modern corporate governance rules, among other things.

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Arthur B. Crozier is chairman of Innisfree M&A Incorporated of New York and of Lake Isle M&A Incorporated, Innisfree's wholly-owned UK subsidiary. Mr Crozier's practice includes the representation of US and international clients in a wide variety of transactions and proxy contests, as well as annual and special meetings. In addition, he counsels an international roster of clients on corporate governance and executive compensation issues. Mr Crozier has written numerous articles and spoken extensively on the subjects of corporate governance, executive compensation, proxy contests, hedge fund activism and international voting practices.

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R&C: Could you provide an overview of shareholder activism in the US banking industry? What overarching trends have you seen in this space during the last 12-18 months?

Main: Historically, activist activity in the US banking industry has been relatively light compared to other industries. The industry is heavily regulated and highly complex operationally, limiting the potential methods for an activist to create shareholder value. Traditionally, activity was concentrated in a few dedicated funds which agitated for the sale of smaller banks to generate outsized returns via M&A vs. operational enhancements or capital restructuring. As US banks remain mired in a challenging operating environment, characterised by low interest rates, fierce competition and heightened regulatory costs, there has been a strong return of bank M&A among the smaller institutions and with it, an increase in activist activity targeting underperforming, many times sub-scale banks. Additionally, in the new 'too big to fail' environment of higher capital requirements and increased regulatory costs for larger institutions, there have been select opportunities to target larger banks that could enhance profitability by divesting underperforming or capital intensive subsidiaries, or reducing the size of certain business lines such as investment banking to return capital to shareholders.

Crozier: There has been an increase in activity at banks generally in the last 12 to 18 months. There are a number of activists that have long targeted smaller banks and they have been picking up their efforts generally, as well as targeting larger banks, such as Webster Financial, which has a market cap of $3.4bn. We believe the pick-up in activity is largely attributable to the expected wave of consolidation in the sector. Larger banks are not immune from activist pressure. Trian Partners targeted Bank of New York Mellon and succeeded in gaining a seat on the board. The presence of a Trian director, however, did not prevent another activist, Marcato Capital, from launching an activist campaign at the bank. Responding to a different form of investor activism, Bank of America decided to submit its recent decision to recombine the offices of chairman and CEO to a shareholder vote due to shareholder dissatisfaction that the change was not included on the agenda at the 2015 Annual Meeting of Stockholders. In a related sector, activism has escalated dramatically at business development companies due to lagging stock price performance and allegations of excessive fees.

Frankl: We have noticed a definite increase in the number of activist campaigns targeting US financial institutions, which includes US banks. Due to increased regulatory burdens, smaller banks have become more attractive to activists pushing a 'sell the company' agenda. Since 2014, there have been significantly more campaigns targeted against banks with less than $1bn in market cap in the financial sector than their large cap counterparts. A vast majority of these new campaigns have related to closed end funds, BDCs and smaller banks, although large banks have not been sheltered completely. Trian settled for a board seat at Bank of New York Mellon in late 2014. Months later, in early 2015, another activist targeted BNY Mellon, calling for a change in CEO. Both BNY Mellon and Citi Group were also subjected to successful proxy access campaigns in 2015, as well as Bank of America which prevailed in a bid to separate the chairman and CEO roles.

Ingles: Shareholder activism in the banking industry has become the subject of widespread media coverage and is increasingly becoming a focus of bank management and boards of directors. Much of the activist activity that we have seen in the industry has involved a handful of investment funds focused on opportunities in the sector and that are dedicated exclusively or primarily to investments in the banking industry. From time to time we also have seen situations involving more high-profile activist investors, such as Nelson Peltz, who now has a representative on the board of Bank of New York Mellon. While the number of observable instances of activism in the industry likely is not sufficiently large to reach many meaningful conclusions about observable trends, we believe activism generally is on the rise in the industry and will continue to be, and we believe activist shareholders have had and will continue to have increasing success in agitating target banks for a sale as the market for bank mergers and acquisitions continues to become more robust.

R&C: How does shareholder activism in the banking sector compare to activity in other sectors? Have you seen a definite increase in activism targeting financial institutions – and if so, why?

Frankl: Due to the highly regulated nature of the banking industry, the opportunity for activist activity is narrower than in other industries. Some 'generalist' funds have agitated for a variety of economic changes including the spinning-off or sale of underperforming business lines or increased dividends, most of which are not specific to the banking industry at all. Most of the small to mid-size banks that activists target have fairly straightforward balance sheets as compared to larger banks, making it less likely that an activist would push for more classic economic activism outside of calling for a sale of the bank. This leaves corporate governance activism or proxy access campaigns as the most common type of activism in that realm of the banking industry. Lastly, we are seeing increased activist activity in less regulated financial institutions such as BDCs and closed end funds, as well as REITs.

Main: The banking sector is distinct from other industries in a variety of ways but the most relevant factors impacting the level of activism are that the sector is heavily regulated with myriad safety and soundness and capital requirements. As a result, capital returns, operational risks and balance sheet flexibility face substantial regulatory scrutiny, and 'control' investments representing greater than 10 percent ownership are subject to regulatory approval. Additionally, the business model is highly complex, limiting opportunities for 'easier wins' from operational and capital structure improvements. For these reasons, most bank activists have pushed for a sale vs. targeting other value enhancing strategies they might in another industry. Since bank M&A in recent years has been concentrated with smaller banks, where buyers are more abundant and regulatory scrutiny less stringent, so has activist activity in the sector. There has been a distinct increase in activism as remaining independent becomes more challenging for sub-scale institutions. With revenue under pressure and costs increasing, one of the only ways to earn appropriate returns is to spread increased costs over a larger asset base, driving consolidation.

Ingles: Our view has been that activist investors generally have fewer options in their playbook when targeting a bank than when targeting companies in other industries, due to the relative simplicity of the business model of most community and regional banking institutions as well as the industry's complex regulatory framework, which affects both the operational and financial flexibility of the bank itself as well as the degree to which one or more investors are legally permitted to take actions that affect control of a banking institution. These factors limit the opportunities available to the activist to propose many of the value-enhancing transactions or initiatives that it might seek to implement in the ordinary course, such as splitting up the company

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or disposing of non-core businesses, utilising excess capital more profitably, or returning it to shareholders, effecting a leveraged recapitalisation, or even in some cases reducing the company's expense base. However, despite these limitations, we do believe we are seeing more instances of shareholder activism in the banking industry recently, and we believe the major reason for this is that the main end-game of activism in the banking industry – agitating for a sale of the institution – has become more viable.

Crozier: As a general matter, activism in the banking sector has been subdued compared to that witnessed in other sectors. This is thanks, in large part, to the layers of regulation on a state and federal level that can significantly hamper an activist's ability to achieve a board seat, the essential objective for an activist seeking real change at a bank. In addition, the usual activist playbook in other sectors, such as breaking up the company, or undertaking large buy-backs or dividend programmes, aren't applicable to small and mid-sized banks. Consequently, even if an activist's publicly expressed agenda is to cut expenses, improve efficiency or other operational objectives, the real goal is usually to seek the sale of the bank at a premium, since that is the only way to make a meaningful profit on their investment in a short-term investment horizon. The expected wave of consolidation in the sector to increase scale due to Dodd-Frank and increased regulation generally is likely driving the increase in activism. For example, activist investors Basswood and PL Capital pressured Metro Bancorp to sell to FNB last summer.

R&C: Have any particular activist campaigns in the US banking arena caught your eye? What lessons can we draw from their outcome?

Crozier: The Bank of New York Mellon and Bank of America experiences demonstrate that no bank is immune due to size or complexity and that banks are vulnerable on a variety of fronts. At Bank of New York Mellon, the agreement to seat a director from one of the most prominent activist investors, Trian Partners led by Nelson Pelz, did not prevent another activist, Marcato Capital Management led by Mick McGuire, a former lieutenant of Bill Ackman at Pershing Square, from also targeting the bank subsequent to the settlement with Trian. At Bank of America, the level of discontent by shareholders because they were not given the opportunity to vote on the combination of the chairman and CEO roles demonstrates the increasing shift to a shareholder-centric model of corporate governance in which institutional shareholders zealously guard their perceived prerogatives. This shift is equally applicable to banks as in other sectors. When given the chance to vote on the issue at the September Special Meeting, however, stockholders overwhelmingly approved the change.

Ingles: All activist campaigns are by definition unique in some way, given the different players and facts in any given case, so it is difficult to focus on any one case as emblematic of any characteristics or trends for activism in the banking industry generally. Some recent cases involving relatively larger banking institutions have resulted in publicly-announced sale or merger transactions, with varying degrees of receptivity to those deals in the market. These recent cases point to the increasing viability of a sale or merger proposal as an activist tactic in the banking industry, and they also sound a warning to bank managements and boards across the industry that preparedness for shareholder activism should be a top-of-mind concern for them as they manage their institutions through persistently difficult regulatory, industry and economic conditions.

Main: Basswood Capital Management's activist position in Astoria Financial. Basswood, a well-respected bank investor with a track record of inducing underperforming banks to sell, announced an approximate 9 percent stake in Astoria Financial in early August of 2015. Astoria Financial, a $15bn asset New York City-based bank, was a rumoured sale candidate given its attractive markets and low levels of profitability, but was focused on remaining independent. By late fall of 2015, approximately three months after the announcement of Basswood's stake, Astoria sold to New York Community Bancorp. The speed in which Basswood prompted a sale was particularly interesting, considering Astoria's preference for independence. Basswood achieved similar successes previously, but with substantially smaller banks. This campaign could serve as a bellwether for activism at larger underperforming banks as M&A returns to this market cap spectrum. The Astoria transaction demonstrates these larger institutions may be subject to the same activist playbook formerly reserved for smaller banks.

Frankl: The May 2013 board meeting was an eventful one for JP Morgan. A collection of corporate governance activists suggested the company require an independent director to take the position as chairman of the board, however the activists were ultimately refuted and Jamie Dimon maintained his position as CEO and chairman. Another notable settlement involved Trian attaining a seat on the BNY Mellon board, which appeared to ultimately result in the announcement of a significant stock buyback. This type of activism is far less common than corporate governance activism in the financial sector. The greatest takeaways are that corporate governance activists have done a pretty good job of getting substantial media attention by concentrating their efforts on industries, such as banking, which may suffer from lingering PR issues from the financial crisis.

R&C: If a bank operating in the US finds itself subject to shareholder activism,

what general steps should it take to address the issue? What role should the board play in these circumstances?

Ingles: The proper course of action for the bank in any given case will depend on the facts and circumstances of the case, but the best course of action for any institution is to begin preparing today by taking steps that may have the effect of addressing typical activist investor concerns before an activist investor gets involved or takes its case public. But once an activist investor has taken a position in the company's stock and has begun publicly or privately agitating for change within the institution in some manner, the company generally will need to take steps to address this development, including at the board of directors, even if the company ultimately concludes that the best course of action would not be to engage in an active dialogue with the activist or not to implement any of the actions being proposed by the activist. Because the activist agenda generally is to improve shareholder value by implementing one or more suggested proposals, this agenda typically will implicate the company's financial performance, its business model or its strategic direction and consideration of strategic alternatives, all of which are matters for review by and direction from the company's board of directors. Banks that are the subject of an activist campaign generally will want to have a plan in place to review and analyse the proposals being put forth by the activist investor and to respond directly to the activist regarding its proposals, as well as, if the activist campaign is public, to address the activist campaign publicly and with the company's various constituencies.

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> *Jason Frankl, FTI Consulting*

Frankl: Even with the best shareholder engagement, activist aggression is not always preventable. If private conversations with activists fail to achieve a mutually agreeable result and the activist does initiate a campaign, senior management and the board of directors must immediately assess their options in order to best position the company to convey its message. The board plays a key role in this type of defence, as they must, in essence, show their work to the investment community. In any type of activist campaign, ultimately shareholders are voting on whether change in the boardroom is necessary. It is vital that the investment community understand the reasons behind the decisions made, so they have confidence in the procedures and credibility of the current board and conclude that change is not necessary.

Crozier: As a general matter, banks confronted by an activist need to take the same steps as other companies. Namely, they should track the trading in the stock to determine if other activists are coming in to the stock and forming a 'wolf pack', candidly assess existing shareholders' views to determine the likely outcome of a proxy contest, develop an outreach programme to key investors and influencers to ensure that the bank's strategy to deliver shareholder value is credible and understood, and take appropriate actions that respond to the activist's concerns, without appearing to be defensive and simply reactive. Directors increasingly play an important role, particularly in outreach to index and quantitative investors who do not have in-depth knowledge of the bank. Many of those investors want to be assured that shareholder concerns are taken seriously at the board level. Directors also play an important part in discussion with the proxy advisory firms in the case of a proxy

contest. In addition, a bank should also reach out to its regulators as soon as possible to notify them of the activist and its proposals and should seek advice from counsel as to the impact of the regulatory scheme on the activists and its ability to achieve its goals.

Main: In reacting to activism, banks are not unique, and an activist's outreach should not be ignored. The CFO or CEO should return an inbound call, and primarily listen to ascertain the thesis. Thereafter, to adequately prepare for a potential contest or negotiation, the company should identify an internal working team, with a focused leader to synthesise information from the full adviser team and empowered to make decisions. Management should receive regular updates and participate in pivotal decisions, but retain latitude to run the business because driving shareholder returns and operational efficiencies can mitigate most critiques. It's also critical to deliver consistent and effective messaging, including concise articulation of the corporate strategy and crafted to actively rebut criticisms, and maintain regular shareholder dialogue including active managers and corporate governance and proxy voting professionals at passive asset managers. The board should be briefed regularly, often weekly, consulted on key decisions – including whether to pursue a settlement – and participate in a proxy contest by communicating with shareholders and advisory firms.

R&C: In your opinion, how important is it for banks to prepare detailed contingency plans before they are targeted by activists? What areas of their business do they need to continually assess for potential weaknesses?

Main: It is critical for a bank to continually review its business from the outside looking in and develop a contingency response plan for possible activist agitation. Most boards conduct regular strategic reviews, however they often exclude ideas that are more evident to outsiders. In this regard, boards should proactively and objectively analyse the viability of any alternative relative to the status quo from a shareholder's perspective as a matter of good corporate governance. Doing so places the company in a position of strength. Ideally, no board or management team should be blindsided by a proposal that has not already been internally vetted, even if Regulation FD precludes an initial substantive comment. Often external parties think more creatively and boards should be open to fresh perspectives and not shy away simply to avoid the appearance of weakness – receipt of credit is less important, whereas driving shareholder value is paramount. The typical bank activist campaign attempts to target an institutions' financial or market underperformance relative to peers and, as a corollary, suggest the bank should 'assess strategic alternatives to maximise shareholder value'. This tactic is effectively asking the bank to sell for a premium. As such, banks should be consistently conducting a review of their competitive positioning and strategic alternatives, understanding how their operational performance stacks-up versus peers, both currently and in the future, as well as evaluating the M&A landscape to justify whether their independent strategy is a superior proposition for shareholders.

Frankl: It is important for banks, particularly large banks, to understand how voting decisions are made by its institutional investors, including pension funds and unions, especially when it relates to corporate governance issues. Ongoing monitoring of shareholder positions, whether large or small is, critical. This should be accompanied by routine perception audits. It is also important for the board to periodically view the bank, as well as its related financial services businesses, through an activist's eyes. This self-assessment should include a review of all public disclosures and statements made to investors and the media to evaluate consistency and follow-through. The board should also periodically review activist campaigns to better understand the areas being explored by activists at competitors, and whether the bank may have similar vulnerabilities. In cases where vulnerabilities are found, detailed plans should be created to address those vulnerabilities. If that is not possible in the near term, proactive communications plans should be created to enable investors to understand its business purpose. Banks also need to know which activists are targeting their industry. They should not only know the track records of those activists, but also the playbook, governance history and returns generated by those entities where these activists successfully attained a board seat. Considerations should include an assessment of all issues the targets experienced after the activist obtained board representation, particularly in the legal and reputational areas.

Ingles: The best preparedness plan for activism for any banking institution is to develop a strong business model and strategic plan on a standalone basis, before any activist investors surface, so as to ensure that the institution is being managed in a way that seeks to maximise its value and returns to its owners. Companies can be proactive in addressing the likely agenda of any activist investor by continually analysing and seeking to improve operational performance and share price, by developing and implementing a long-term strategic plan, including regularly reviewing and analysing the company's strategic alternatives for enhancing value to shareholders, and by regularly communicating this performance and plan to and building stronger relationships with its significant investors. Doing so can result in the institution already having considered any plan or course of action that may be proposed by an activist if and when one surfaces. Of course, this may include analysing the possibility of a merger or sale as one strategic alternative available to the institution, including the value reasonably achievable in such a transaction and the risks and contingencies associated with negotiating, announcing and completing such a transaction. Banks also should have in place a plan to more directly anticipate, identify and respond to activist investors when they surface, including a programme to monitor activity in its stock and a contingency plan for coordinating a team both within the institution and among its outside advisers to

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review any activist proposals and to respond to them – including publicly if appropriate – in an effective manner.

Crozier: To assess and mitigate their vulnerability to an activist campaign, it is vital for banks to prepare a detailed contingency plan that ideally starts before the activist appears. Among other things, the contingency plan needs to identify the issues an activist is likely to target and lay out the alternatives to address those issues to the fullest extent possible. In any activist situation, the credibility of the management and board is key to a successful outcome, so it is important to ensure that shareholders feel that the bank's leaders are aware of any issues that impede shareholder value creation and are taking effective steps to address those issues, even if the ultimate resolution is long-term. No company can build that level of credibility if it starts the necessary communication and engagement only after a proxy contest has begun.

R&C: In today's market, where there is a clear drive toward transparency and accountability across the financial services sector, what is your advice to banks on maintaining an effective shareholder communications strategy?

Crozier: An effective shareholder communications programme which demonstrates that the board and management team is executing on a well thought-out, credible strategy to deliver robust shareholder value, even if not on a short-term investment horizon, is critical to deterring an activist in the first place and to fending off any activist that does appear. In the banking industry, transparency is critical for any such strategy to be viewed as credible. Similarly, accountability is critical to maintaining credibility if the strategy fails in whole or in part.

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Ingles: We consistently advise that regular periodic communication with shareholders regarding the company's financial position and outlook and its strategic direction is a recommended best practice for public companies in all industries, not just banks.

Ensuring that the institution's largest investors understand the company's financial condition, its business model, its strategic direction and outlook and risks involved in managing towards those goals, and that those investors also have an opportunity to engage in a dialogue with managers about these matters, can be the best way to address the types of concerns that activist investors typically raise if and when they surface.

Frankl: Banks need to pay even closer attention to shareholder engagement and sentiment than most industries. Fortunately, many banks do an excellent job of maintaining a great dialogue with shareholders; however, often more can be done. Independent feedback through anonymous surveys to institutions and other large investors is a great way to receive credible and unfiltered feedback on whether the bank's messaging is being received as intended. This feedback should be presented directly to the board.

Main: Given the level of regulatory scrutiny in the banking sector, transparency and accountability have become paramount across the industry. In this environment, an effective shareholder engagement strategy that features a consistent message to shareholders and analysts is critical to maintaining an open dialogue with investors. By capturing and responding to investor feedback, management teams can potentially avoid blindspots that an activist might exploit. The company can also create goodwill with its key holders by adopting certain governance or other policies that can carry favour in a proxy contest should one arise. An honest assessment of the company's performance on several dimensions, including TSR, operating performance and balance sheet relative to expectations is important to understanding how the company is perceived and measured by shareholders. Utilising this information as a basis for shareholder communications will help to maintain an effective dialogue with the investment community.

R&C: Looking ahead, do you expect to see more shareholder activism targeting the US banking industry? What do you believe banks need to do in response to this growing trend?

Frankl: Activism targeted towards smaller to mid-size banks will persist as it has throughout the recent past. As long as activists can find weaknesses in business operations and strategies, or an opening to push for the sale of a smaller bank, this pattern will continue. To respond to this, these banks and financial institutions need to be diligent in monitoring who they speak with at conferences, all participants on investor conference calls and also which activists are active in the industry. Our independent survey of activist investors, done in conjunction with Activist Insight, has shown that most will begin researching possible targets up to a year before making an investment. Furthermore, investors in our survey overwhelmingly believed that assets allocated to shareholder activism would continue to increase. Concurrently, 86 percent of the funds we surveyed expect to engage in new capital raising over the next 12 months in order to put these funds to work and generate competitive returns for investors.

Main: Broadly, we continue to see an increase in the flow of funds into the hands of activist investors given this has become an asset class of its own over the years. Activist returns have outpaced the MSCI since 2008, which has attracted new investors over the last few years at an approximate 25 percent CAGR from 2010 through mid-2015 and is estimated at over $130bn in publicly-identifiable AUM. Specifically, the banking sector is highly competitive and outsized returns are generally driven through M&A, particularly in this challenging operating environment where many smaller banks don't earn their cost of capital. As such, activism has increased as M&A remains a key investment thesis in both perceived buyer and perceived seller bank stocks. Banks should prepare for an approach similar to companies in other sectors utilising best practices. As a regulated industry, an approach can be more difficult and tactics are more limited in what an activist can exploit, but banks are by no means 'off limits' to an approach.

Crozier: Now that hedge fund activism is an asset class, no industry or company can be considered completely immune from activism. We expect to see increasing activism in the banking industry, in particular. The prospect of significant short-term profits from M&A activity in the sector will be a powerful lure for activists that have not previously been involved in financial institutions. Banks need to be aware that they are vulnerable and identify the specific areas of vulnerability. They need to engage effectively with their shareholders by communicating a well thought-out, credible strategy to deliver robust shareholder value, albeit not necessarily in the short-term, and demonstrate that they listen and respond to the concerns of their shareholders.

Ingles: We do believe that we will see increasing incidences of shareholder activism in the sector in the future. And we believe banks should seek to pre-empt any activity in their own institutions by taking the preparatory steps outlined above to address typical activists concerns before an activist surfaces and to be best prepared to mobilise to respond to any activist campaign that arises. R&C