

Milbank

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# Corporate Governance Group

# Client Alert

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## SEC APPROVES NYSE RULE AMENDMENT ELIMINATING BROKER DISCRETIONARY VOTING IN ALL ELECTIONS OF DIRECTORS, WHETHER OR NOT CONTESTED

On July 1, 2009, the Securities and Exchange Commission (“SEC”), by a 3 to 2 vote, approved a New York Stock Exchange (“NYSE”) rule amendment that will eliminate broker discretionary voting in all director elections.<sup>1</sup> As a result of this amendment, uncontested director elections will no longer be considered “routine” matters on which brokers may vote in their discretion in the absence of client instructions. Because individual shareholders whose shares are held in “street name” frequently do not take the time to furnish their brokers with voting instructions, and brokers historically have tended to exercise their discretion to vote for the management slate, this amendment to NYSE Rule 452 could have a profound impact on director elections, particularly for companies that have adopted majority, as opposed to plurality, voting for directors.

This amendment to NYSE Rule 452 will be applicable to proxy voting for shareholder meetings held on or after January 1, 2010.

### *Background to NYSE Rule 452*

NYSE Rule 452 enables brokers to vote their clients’ shares in their discretion on matters deemed “routine” by the NYSE, but only if the broker sends proxy materials to the beneficial owners of the shares and does not receive voting instructions at least 10 days before the shareholder meeting in question. Until now, “routine” matters have included uncontested director elections where no candidates have been named in opposition of the incumbent board’s slate, which remain the norm in corporate America.

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<sup>1</sup> See NYSE Rule 452, titled “Giving Proxies by Member Organizations.”

From the time this amendment to Rule 452 was first proposed by the NYSE in 2006,<sup>2</sup> opponents have urged the SEC to delay approval pending a comprehensive review of the entire proxy solicitation and voting system. Shareholder activists and institutional investors, on the other hand, have argued that the discretionary broker vote violates the core governance principle of “one share, one vote,” and thwarts their attempts to affect corporate governance through “withhold the vote” campaigns.<sup>3</sup>

However, the recent failure (or near failure) of so many titans of corporate America, particularly in the financial services industry, and the related adverse impact on the economy, coupled with new leadership at the SEC determined to adopt measures aimed at enhancing investor confidence in a weakened financial system, brought the amendment back to the forefront.<sup>4</sup> The SEC, in tossing out the decades old classification of uncontested director elections as “routine,” noted that this change is “designed to enhance corporate governance and accountability by helping assure that investors with an economic interest in the company vote on the election of directors.”<sup>5</sup>

### *Potential Consequences*

In analyzing the proposed amendment, the SEC reviewed and examined over 150 comment letters, some of which raised the following potential issues and consequences:

*Ability to Achieve a Quorum and Related Costs.* The elimination of broker discretionary voting may make it difficult for some companies (particularly smaller companies without large institutional shareholder followings) to achieve a quorum at their annual meetings. Under the amended rule, brokers may not be entitled to submit proxies on behalf of the many retail holders who often neither vote nor provide their brokers with voting instructions and, as a result, their shares will not be counted for quorum purposes. This could in turn raise the cost of achieving a quorum at annual shareholder meetings due to intensified efforts to communicate with retail and other shareholders, urging them to participate in director elections and vote for the board nominees. These efforts could include the retention of proxy solicitors, even in uncontested elections.

One way to address this quorum concern would be for a company to include at least one “routine” item on the proxy card, such as ratification of auditors (as many companies already regularly do). In this way, brokers who do not receive instructions will nevertheless be able to submit proxies that cast votes on the routine matter only, and the shares represented thereby will be counted for quorum purposes even though they are not voted on the election of directors.

*Disenfranchisement of Retail Shareholders and Influence of Third Parties.* Critics of the proposed amendment raised the concern that the elimination of broker discretionary voting could have the consequence of disenfranchising shareholders who believe that their brokers can and will vote their shares on their behalf if they do not.<sup>6</sup> Some voiced the concern that the rule change could “magnify difficulties issuers have in

<sup>2</sup> See our Client Alert entitled “NYSE Proposes To Abolish Discretionary Broker Voting In Elections Of Directors,” dated October 31, 2006.

<sup>3</sup> The “withhold the vote” campaign is a planned, concerted effort to convince fellow shareholders to withhold their vote from one or more directors in an uncontested election with the goal of communicating shareholder dissatisfaction to the board.

<sup>4</sup> Similarly, the SEC recently proposed amendments to the proxy rules that would, for the first time, provide access to shareholders to company proxy statements in order to nominate candidates for election as directors. See our Client Alert entitled “SEC Proposes Long-Awaited Proxy Access Rules,” dated June 22, 2009.

<sup>5</sup> SEC Release 2009-147, “SEC Proposes Measures to Improve Corporate Governance and Enhance Investor Confidence.”

<sup>6</sup> The counter to this argument, of course, is that shareholders who do not vote or give voting instructions are disenfranchising themselves, and it is not appropriate for brokers, who do not have an economic stake in the shares, beneficially owned by their customers, to have direction as to how those shares are voted.

communicating with shareholders,” especially with objecting beneficial owners (“OBOs”) whose shares are held in street name and who have not agreed to the release of their names and addresses. Others argued that under “Notice & Access” – the SEC’s new rules providing for the electronic delivery of proxy materials<sup>7</sup> – retail shareholder participation in company elections has decreased significantly, and that this amendment would further shift “disproportionate weight to institutional investors, and increase power in the hands of the few shareholders who vote.”<sup>8</sup> Finally, some also raised the concern that the elimination of broker discretionary voting could increase the influence of the proxy advisory firms who provide voting recommendations to these institutional investors.

*Impact on Companies with Majority Vote Standards For Election of Directors.* The elimination of broker discretionary voting will, in the case of the many companies that have recently adopted majority voting for director elections, raise the bar for directors to be elected. With fewer votes cast, particularly by retail shareholders, it could be more difficult for an incumbent standing for election to receive the number of votes necessary for his or her election (a majority of the votes cast) if institutional shareholders are not happy with the company’s performance (or other actions of its board) and decide to vote against or withhold their votes from the director’s election. This would particularly be true in cases where activist shareholders have launched a campaign to deny such director a majority vote.

This would be less of a concern for companies that have a plurality vote standard, where all candidates in an uncontested election are elected as directors, regardless of whether the shares voted for that person constituted a majority of the shares cast. However, even in the case of companies that have maintained plurality voting, a “withhold the vote” campaign seeking to express disfavor – and perhaps a lack of shareholder confidence – with incumbent directors whose re-election is guaranteed due to the absence of a competing slate of directors could be more potent if brokers do not vote due to a lack of customer instructions.

### ***Conclusion***

In light of the recent amendment to NYSE Rule 452, companies must thoughtfully analyze the potential impacts of the elimination of broker discretionary voting in uncontested director elections on their ability to (i) solicit a quorum at their annual meetings, (ii) reach out to retail (and particularly OBO) shareholders to vote for their director nominees, (iii) elect directors who are subject to majority voting requirements and (iv) combat a “withhold the vote” campaign. Many companies may consider adding (if they do not already do so) “routine” matters, such as ratification of their auditors, to matters voted on by shareholders so that brokers who have not received voting instructions may nevertheless vote their customers’ shares and participate in a quorum at the annual meeting. More companies also may wish to retain proxy solicitors, even in uncontested elections, in order to increase the likelihood of reaching a quorum and enhancing their ability to re-elect incumbent directors. Finally, some companies might even consider extending the period between the mailing of the proxy and the annual meeting in order to ensure that they are able to reach out to enough shareholders and solicit votes.

For many companies, the amendment to NYSE Rule 452 may effectively end what they used to consider to be “routine” annual elections. In response, companies, in advance of their next annual meeting, should put in place procedures that will help ensure as large a turnout for the annual director election as possible.

<sup>7</sup> See our Client Alert entitled “SEC Adopts New Rules Permitting Web Posting Of Proxy Materials” dated February 14, 2007.

<sup>8</sup> See SEC Release 34-60215.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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