SEC ELIMINATES DISCRETIONARY BROKER VOTING FOR UNCONTESTED DIRECTOR ELECTIONS

On July 1, 2009, the Securities and Exchange Commission (SEC), in a divided 3-to-2 vote, approved a long-anticipated amendment to New York Stock Exchange (NYSE) Rule 452 to prohibit brokers holding shares in "street name" for their clients from voting in uncontested director elections on behalf of the clients without receiving specific voting instructions from those clients. The amended rule will apply to proxies for shareholder meetings held on or after January 1, 2010.²

Amending NYSE Rule 452

In 2005, the NYSE created the Proxy Working Group to review the NYSE rules regulating the proxy voting process.³ The Proxy Working Group issued its original report in June 2006, and issued an addendum to its original report in August 2007.⁴ The reports recommended a number of changes and proposals with respect to the proxy system, one of which was that the NYSE should "amend Rule 452 to make the election of directors a 'Non-Routine' matter," meaning that brokers would no longer be permitted to vote the shares of beneficial owners who do not give specific voting instructions with respect to the election of directors. The Proxy Working Group recommended that these changes be considered together, as part of an integrated examination of the proxy voting system.

The SEC reviewed the Proxy Working Group's recommendations and held a series of "roundtables" on the proxy system. Yet the SEC did not take up the broader agenda, and as part of that process postponed consideration of the amendment to NYSE Rule 452 for several years. However, earlier this year it solicited additional comments regarding the amendment from interested parties, which are available at http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692.shtml. According to the SEC's order approving amended NYSE Rule 452:

- It received 153 comment letters from 137 commentators.
- Twenty-eight commentators (20 percent) explicitly supported the proposal.
- Twelve commentators (9 percent) explicitly opposed the proposal.
- Ninety-seven commentators (71 percent) neither explicitly supported nor opposed the proposal, of which:
  - Ninety-five commentators expressed concerns with the proposal as written.
  - Ninety-three commentators urged the SEC not to take action on the proposed rule at this time.

The SEC's Split Vote Approving the Amendment to NYSE Rule 452

Despite the concerns of some commentators, the SEC approved the amendment to NYSE Rule 452.

Background

NYSE and SEC rules require that brokers deliver proxy materials to the beneficial owners of shares held by them and request instructions from each beneficial owner as to how to vote such shares at each shareholder meeting. NYSE Rule 452 permits brokers to exercise discretionary voting authority on "routine" matters when voting instructions are not received from a beneficial owner 10 days prior to the shareholder meeting.

Unlike contested director elections, uncontested director elections have until the recently approved amendment been considered routine matters under NYSE Rule 452. The recently approved amendment to NYSE Rule 452 now provides that uncontested director elections are no longer routine matters over which brokers can vote without instruction from their clients.⁵

¹ Many stockholders hold shares in publicly traded companies through a broker, trustee, or nominee, rather than directly in their own name. When shares are held in a brokerage account or by a bank or another nominee, the stockholder is considered the "beneficial owner" of shares held in "street name."
³ NYSE Rule 452, as amended, includes a narrow exception for registered investment companies, and also codifies two existing interpretations that prohibit broker discretionary voting for material amendments to investment advisory contracts.
⁴ The Proxy Working Group was chaired by Wilson Sonsini Goodrich & Rosati Chairman Larry Sonsini, and Wilson Sonsini Goodrich & Rosati partner David Berger served as counsel to the Proxy Working Group.
⁵ The Proxy Working Group's June 2006 report and August 2007 addendum are both available on the NYSE's website.
Commissioners Casey and Paredes opposed the amendment, at least at the current time. In a statement, Commissioner Paredes indicated that:

- NYSE Rule 452 should be addressed as part of a comprehensive assessment of the proxy voting system instead of being amended in isolation.

- Eliminating broker discretionary voting, without other changes to the proxy process, may suppress the voice of retail shareholders, or individual investors who hold their shares through brokers in street name, to the benefit of institutional shareholders.

Chairman Schapiro and Commissioners Aguilar and Walter supported the amendment, indicating that:

- The amendment was designed to help assure that voting rights for director elections are exercised by those with an economic interest in the company, rather than by brokers, thereby improving corporate governance and enhancing accountability.

- Action on the NYSE's rule request was long overdue.

- The SEC's proxy rules should undergo a thorough review, but approval of NYSE Rule 452 should not be postponed until such a review can take place.

Given the widespread effect of the amended rule, and following the recommendation of the Proxy Working Group, each commissioner suggested that the NYSE lead a large-scale investor-education effort to inform shareholders about the proxy voting process.

Effects of the Amendment to NYSE Rule 452

The direct effect of the amendment to NYSE Rule 452 is that, beginning with shareholder meetings held on or after January 1, 2010, brokers cannot vote shares on behalf of their clients in any director elections without specific voting instructions from their clients. This potentially decreases the number of votes cast in director elections, especially by so-called “retail” investors, or individual investors who hold their shares in street name.

It is estimated that as much as 70 to 80 percent of the shares of U.S. public companies are held in street name and managed by brokers. In 2008, 16.5 percent of shares were voted by brokers exercising discretionary voting, according to Broadridge Financial Solutions. Historically, brokers exercising discretionary voting authority voted overwhelmingly for management nominees.

In recent years, with the increase of majority voting in director elections and the advent of electronic proxy access, companies have seen a decrease in the vote held by retail investors. With the amendment to NYSE Rule 452, companies may see an additional decrease in the retail vote, potentially making it more difficult to elect directors nominated by management.

What You Should Do Now

Companies should consider taking the following actions in response to new NYSE Rule 452:

- To alleviate the effect of new NYSE Rule 452 on obtaining a quorum for an annual shareholder meeting, ensure that there is at least one proposal on the company's proxy card that is still “routine” under new NYSE Rule 452, such as the ratification of auditors. So long as there is at least one routine proposal on the proxy card, broker non-votes, or an indication from a broker that they have not received instructions from a client on a routine matter, are generally counted for purposes of establishing a quorum for the annual meeting under Delaware law.

- Know the composition of your shareholder base and be aware of changes to the base. For example, what percentage of your shareholders are institutional investors and what percentage are retail investors? Which institutional investors have long-term investment strategies with respect to your company and which have short-term strategies? What has been the impact of discretionary voting on past director elections? Understanding the composition of your shareholder base can assist you in understanding how significant the effect of the amendment to NYSE Rule 452 will be on the election of directors in the future and can help guide decisions about engaging with your shareholders, both during the year as well as during proxy solicitations. Having an ongoing relationship with a proxy solicitor can be useful here, as they can assist in these analyses.

- Consider hiring a proxy solicitor in connection with your annual shareholder meetings to help secure the vote on management's proposals. Also, discuss with your counsel and proxy solicitor the advisability of ordering a “non-objecting beneficial holder” (NOBO) list in connection with the annual meeting to facilitate communications and direct solicitation with street-name shareholders.

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7 See the Proxy Working Group’s comment letter.

8 Not including meetings originally scheduled to be held before January 1, 2010, but that are postponed until after January 1, 2010.

9 In recent years, a number of brokers, holding as much as 45 percent of the shares of U.S. public companies, have adopted “proportional voting,” whereby the brokers vote uninstructed shares in the same proportion as votes from clients who provide instructions.

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shareholders. Depending on the circumstances of your director election, you may need to budget for additional costs relating to follow-up mailings and telephone solicitation of retail investors.

• Check majority voting provisions that your company has adopted, if any, with respect to the treatment of abstentions and broker non-votes in the outcome of director elections (i.e., if a majority vote is defined as votes cast “for” a candidate exceeding votes cast “against” a candidate, abstentions and broker non-votes will have no impact; if a majority of outstanding shares is required, abstentions and broker non-votes will make it more difficult to receive approval).

• Take a more comprehensive, year-round view of director elections. For example, understand what board actions would cause a proxy advisory group, such as RiskMetrics (ISS), to recommend voting against a director nominee at an annual meeting. Since many proxy advisory groups recommend voting against director nominees as a result of perceived corporate governance concerns, consider periodically conducting a review of your company’s corporate governance policies and procedures.

Please contact David J. Berger, Bradley L. Finkelstein, Katharine A. Martin, Richard Cameron Blake, Vijaya V. Gadde, your regular Wilson Sonsini Goodrich & Rosati contact, or any member of the firm’s corporate and securities practice or securities litigation department with any questions you may have about these matters and the potential implications they could have for your company.