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The SEC Approves the Elimination of Broker Discretionary Voting in All Director Elections

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On July 1, 2009, the Securities and Exchange Commission (SEC) approved a landmark amendment to New York Stock Exchange (NYSE) Rule 452, Giving Proxies by Member Organizations (Rule 452). The amendment prohibits broker discretionary voting in all director elections, including uncontested elections, at stockholder meetings held on or after January 1, 2010 (other than 2009 annual meetings properly adjourned to 2010). Although companies registered under the Investment Company Act of 1940 are expressly exempted from the amendment, because Rule 452 applies to brokers who are members of the NYSE, it will impact nearly all other public companies. This includes companies listed on the NYSE, the Nasdaq Stock Market LLC and other national securities exchanges, as well as those traded in the over-the-counter market through quotation platforms such as the OTC Bulletin Board™ and the Pink Sheets®. The amendment to Rule 452 has the potential to dramatically impact the convening and outcome of uncontested director elections held by U.S. public companies. Issuers should begin preparing for this impact immediately to be ready for the upcoming 2010 proxy season.

Current Framework

There are two forms of stock ownership in the U.S.: record and beneficial. A stockholder of record (often referred to as a "registered" holder) owns shares in its name. Record holders generally include parties who receive securities directly from the issuer, including insiders and other employees, private placement investors and strategic partners. Stockholders of record have the right to vote their shares directly at stockholder meetings, either by delivering a proxy to the issuer or by voting in person at the meeting.

A beneficial owner (often referred to as a "street name" holder) holds its shares indirectly through a broker, bank, depository or other intermediary in some form of brokerage or other customer account maintained with the intermediary. An estimated 70-80% of all U.S. public company stock is held in street name, by both retail stockholders (i.e., individuals) and institutional stockholders. Each beneficial holder is further classified as either a non-objecting beneficial owner (NOBO) or an objecting beneficial owner (OBO). An OBO is a beneficial holder who has instructed its intermediary not to divulge the beneficial holder's identity, address or stock position to the issuer; whereas, a NOBO permits the intermediary to disclose this information. OBOs are reported to represent approximately 75% of shares held in street name, which means companies generally do not know (and cannot obtain) the identities and contact information of the holders of a significant percentage of their shares.

Unlike record holders, beneficial owners typically do not have the right to vote their shares directly at stockholder meetings. Instead, a depository institution, such as The Depository Trust Company (DTC), is deemed to be the stockholder of record of these shares and, as a result, it has the legal right to vote the shares. DTC and other depository institutions are owned by participants, which include the brokers, banks and other institutions who act as intermediaries on behalf of street name holders. Since depository institutions have no beneficial interest in the shares registered in their names, they typically pass their legal voting rights through to their intermediary participants by granting them an "omnibus proxy." The omnibus proxy gives the intermediaries the authority to vote shares at stockholder meetings.

To give street name holders the voting rights that typically attach to stock ownership, however, SEC and NYSE rules require that intermediaries solicit voting instructions from their beneficial holder clients. Most brokers outsource this function to Broadridge Financial Solutions, Inc. (formerly Automatic Data Processing, Inc.). Typically Broadridge solicits instructions by forwarding the issuer's stockholder meeting notice, proxy statement, annual report and other proxy materials to the beneficial owners along with a voting instruction form (VIF), which may be completed and returned to Broadridge, and also provides instructions as to how stockholders can vote via the Internet or by telephone. With respect to an issuer relying on the SEC's "notice only option" (i.e., "e-proxy"), which allows the issuer to solicit proxies by making proxy statement materials available to stockholders through the Internet rather than by delivering them by mail, Broadridge transmits the required notice of Internet availability of proxy materials to the beneficial owners. The notice provides beneficial owners with instructions for accessing the issuer's proxy materials online and voting via the Internet, as well as instructions for requesting a paper copy of the proxy materials if desired. Each beneficial owner can indicate its voting preferences either by completing the VIF and returning it to Broadridge or by voting via the Internet or by telephone. Broadridge then tabulates the votes received from beneficial owners and transmits them to the issuer's transfer agent or inspector of election.

Under Rule 452, if an NYSE member-broker receives voting instructions from a beneficial owner by the tenth calendar day before the scheduled stockholder meeting date, the broker is required to vote the street name shares according to the beneficial owner's instructions. However, provided that adequate and timely disclosures have been made to the beneficial owner, if the broker has not received instructions from the beneficial owner by this date, Rule 452 provides brokers with the discretionary authority to vote the beneficial holder's shares on all matters other than those considered "non-routine" under NYSE regulations. This is known as the "ten-day rule."

A "non-routine" matter includes a merger, consolidation or any other matter that "may affect substantially the rights or privileges" of an issuer's stock. Under current Rule 452 (i.e., prior to the amendment), the election of directors is considered a "routine" matter unless the election is contested. The NYSE interprets "contested" to mean that the election is either subject to a counter-solicitation against management's director nominees using a separate proxy card and other materials, or part of a proposal made by a stockholder that is being opposed by the issuer's management. Director elections involving "withhold vote" and "vote no" campaigns, as well as related activities by activist stockholders that merely urge stockholders not to vote "for" directors supported by management, are considered "uncontested" for purposes of Rule 452. Accordingly, brokers historically have been permitted to use their discretion to vote in these types of elections under the ten-day rule. Banks, as well as other intermediaries who are not NYSE members, are not subject to Rule 452 and do not have authority to vote uninstructed shares on any matter.

Implications of the Amendment

The amendment to Rule 452 may have far-reaching consequences for issuers, institutional and retail stockholders, proxy advisory firms and annual stockholder meetings generally, including the following:

Institutional Stockholders May Exercise Greater Control in the Outcome of Director Elections

According to Broadridge, voting instructions were submitted for fewer than 32% of shares held by retail stockholders during the 2009 proxy season. The percentage was under 28% for companies using e-proxy. As a group, institutional stockholders – generally, private and government pension plans, investment advisers, insurance companies, depositories and municipalities – are far more likely than retail stockholders to submit voting instructions to their brokers. Many institutional stockholders are contractually obligated to vote their shares at stockholder meetings or otherwise have a fiduciary obligation to their clients to do so. Despite historically low levels of voter participation among retail holders, however, their shares typically have been voted at annual stockholder meetings because most brokers exercise discretionary voting in director elections under Rule 452.

If the voting patterns of retail stockholders continue at the same (low) levels, institutional stockholder votes are likely to carry greater weight in director elections going forward. The impact will be more dramatic among companies that have more concentrated retail ownership, such as orphan or other small cap companies without securities analyst coverage to attract significant institutional investor interest.

Increase in the Number of Failed Director Elections

A failed election occurs when one or more director candidates nominated by or on behalf of the issuer does not receive the minimum number of "for" votes necessary to elect the director pursuant to the issuer's bylaws or under applicable law. Election failures can result in significant board disruption and often generate negative publicity for issuers. In some cases a failed election may cause an issuer to be in breach of national securities exchange corporate governance requirements and place the company at risk of being delisted.

According to data collected by both the NYSE and Broadridge, brokers exercising discretionary authority vote "overwhelmingly" with management in director elections. As a group, retail stockholders who submit voting instructions typically also vote with management in director elections. Together these voting patterns have given issuers a high level of assurance that most of their retail shares would be voted in favor of their nominees, even in cases where only a small percentage of retail holders actually submitted voting instructions to their brokers.

Institutional stockholders generally are more likely than retail stockholders to oppose management's nominees for director, propose a competing slate of candidates and organize "vote no" and "withhold vote" campaigns against incumbent directors. Many institutional stockholders have provisions in their governing documents that prohibit them from voting in favor of management's nominees if an issuer has adopted, or failed to adopt, certain practices or procedures considered not to be in the best interests of the institution or its clients. In addition, many institutions rely heavily (or exclusively) on recommendations provided by proxy advisory firms like RiskMetrics Group, Inc., Glass Lewis & Co., LLC and PROXY Governance, Inc. in determining how to vote in director elections. These advisory firms routinely demand the adoption of a fairly rigorous set of corporate governance and related

practices, policies and guidelines by issuers, and often recommend that their institutional stockholder clients vote against director nominees of issuers who fail to comply with one or more of these measures. During the last few years, proxy advisory firms have become increasingly critical of the corporate governance and executive compensation practices of companies and more demanding of boards and management. Recognizing that the elimination of discretionary voting in all director elections is likely to increase institutional stockholders' influence at future annual meetings, these stockholders and proxy advisory firms may view the amendment to Rule 452 as a ripe opportunity to further advance their agendas and become even more active in the director nomination and election process. This may lead institutional stockholders to propose a greater number of competing director slates and launch "withhold vote" or "vote no" campaigns against management's nominees with greater frequency going forward. Without the historically significant percentage of broker discretionary votes in director elections supporting management's nominees, these campaigns are more likely to be successful in the future.

Issuers who have adopted "majority voting" bylaws may witness an even greater rate of failed elections. Under majority voting, director nominees must receive "for" votes from a majority of the shares represented at the meeting (or in some cases, outstanding) to be reelected. With the conventional plurality standard, by contrast, a director nominee could be reelected with only one "for" vote. Since 2006, a number of public issuers, including more than 50% of issuers in the Standard & Poor's 500 Index, have adopted majority voting. The elimination of broker discretionary voting coupled with the adoption of majority voting will effectively raise the bar that management's nominees must meet in order to be reelected. Some issuers who previously adopted majority voting may choose to revert to plurality voting or transition to a "plurality-plus" standard, whereby a director nominee who fails to receive "for" votes from a majority of the shares represented at the meeting (or outstanding) must tender a "contingent" resignation to the company, which would be accepted or rejected by the company's board of directors within a prescribed period of time after the meeting. Those companies currently using plurality voting may be less inclined to move to a majority voting standard.

Issuers May Have More Difficulty Obtaining a Quorum

In order to transact business at a meeting of stockholders, a quorum of the issuer's stockholders must be present. Although quorum requirements vary by issuer, typically the holders of a majority of the issuer's outstanding shares must be present or represented by proxy at the meeting to have a quorum. Votes tendered by brokers, banks and intermediaries, including those submitted by brokers through discretionary voting under Rule 452, are deemed to be represented at the stockholder meeting for purposes of establishing a quorum. Moreover, broker discretionary voting on a single routine matter counts toward the quorum requirement for purposes of all business transacted at the meeting, not just the routine item(s). Therefore, unless an issuer includes at least one routine item (such as the ratification of the selection of the issuer's independent registered accounting firm) in its annual meeting agenda going forward, the amendment to Rule 452 may place the issuer at greater risk of failing to achieve a quorum, leading to a postponement until the stockholder meeting can be convened with the requisite quorum. Until the required quorum is achieved, the issuer is unable to conduct any business on the agenda for its stockholder meeting.

Issuers May Be Less Likely to Adopt or Continue to Use E-Proxy

Since 2007, companies have been eligible to furnish their annual meeting proxy materials to stockholders through a "notice only" model often referred to as "e-proxy." E-proxy was adopted in large part to allow issuers to reduce their expenses in complying with the proxy delivery rules. Broadridge reported that, from July 2008 through May 2009, more than 1,300 corporate issuers used the notice only method to distribute proxy information to stockholders and that, since July 2007, U.S. corporate issuers using notice only saved approximately $400 million on printing and postage fees.

According to the same report, however, issuers using e-proxy have lower rates of voter participation among retail holders at annual meetings than issuers who continue to use the traditional "paper" delivery model. In some cases, the difference in participation levels is substantial. In light of these statistics, some issuers may conclude that the risks associated with lower retail turnout do not justify the cost savings and administrative benefits offered by e-proxy. Companies who have used e-proxy in prior years may elect to revert to the traditional system of delivery in an effort to increase participation among retail holders, while others who used the traditional paper model in 2009 may be less inclined to adopt e-proxy in the future.

Annual Meetings May Become a More Expensive and Time-Consuming Process for Issuers

A report commissioned on behalf of the NYSE noted that "there appears to be a general lack of understanding in the investor community with respect to the proxy voting process." This is supported by the following data contained in the report:

- 41% of retail holders incorrectly believed that shares purchased through a brokerage firm were automatically registered directly in the holder's name;
- 33% of retail holders were unaware whether, and how, their street name shares would be voted at meetings if they did not provide voting instructions to their brokers;
- 30% of retail holders believed their street name shares were not voted at all at meetings (on any matter) if they did not provide voting instructions to their brokers; and
- A significant number of retail stockholders with shares held in street name were unaware of the NOBO/OBO system and how they were classified with their brokers under the system.

This data suggests that a large percentage of retail holders are unlikely to understand how their failure to submit voting instructions to their brokers will influence the outcome of future annual meetings. Many issuers will need to actively educate retail holders about why it has become critically important for them to participate in the voting process and become more aggressive in soliciting their votes. This may require issuers to prepare educational materials for retail stockholders, send additional mailings to stockholders, directly contact NOBOs to encourage them to vote and/or hire proxy solicitors, all of which entail additional time and expense to the issuer. Issuers who fail to achieve a quorum by their initially scheduled meeting dates may need to postpone their meetings in order to solicit additional proxies, adding further time, distraction and cost to the process.

Alternatives Rejected by the NYSE

A number of parties who submitted comments to the SEC in response to the NYSE's proposal supported preserving uncontested director elections as a routine matter, but requiring brokers who exercise discretionary voting to use either a proportional voting or client directed voting (CDV) approach. Under proportional voting, a broker would vote uninstructed shares in the same proportion as those shares for which it actually receives voting instructions from the broker's other beneficial holders. In a March 2009 letter to the SEC, Broadridge indicated that 11 of the "largest brokerage firms," which represent more than 45% of the accounts held by brokerage firms, use proportional voting. Under CDV, at the time the beneficial holder opens a brokerage account, the holder would be required to provide its broker with "good until cancelled" voting instructions with respect to all matters presented at stockholder meetings, including director elections. In the event the broker did not receive subsequent voting instructions from the beneficial holder with respect to a specific annual meeting matter, the broker would vote the shares according to the beneficial owner's initial instructions. Neither proportional voting nor CDV was discussed at the SEC's open meeting at which the amendment to Rule 452 was approved.

Advice for Issuers

The amendment to make uncontested director elections a "non-routine" matter has the potential to dramatically change the dynamics and outcome of annual stockholder meetings, particularly among companies with a greater proportion of retail stockholders. To prepare for the 2010 proxy season, issuers should consider taking the following actions:

Gather data relevant to the proxy solicitation and voting process. Issuers should first clearly understand the composition of their stockholder base, including the percentage of shares held in record name versus street name, the split in ownership between institutional and retail holders and the number of street name shares held by OBOs versus NOBOs. Issuers also should collect information relating to each group's recent voting participation levels and patterns, as well as the number of shares voted through broker discretionary authority at their 2009 annual stockholder meeting. These data points will need to be evaluated carefully in order to assess the likely impact of the amendment to Rule 452 on the issuer's 2010 annual meeting.

Issuers may also benefit by reviewing the guidance issued by proxy advisory firms on a regular basis in order to gauge how their institutional stockholders are likely to vote in future director elections. Companies should review the reports on their corporate governance and executive compensation practices issued by these advisory firms closely to ensure they do not contain any inaccuracies that may (incorrectly) result in a negative rating or "withhold vote" recommendations from these firms.

Assess the impact of using e-proxy. In light of the evidence correlating the use of e-proxy with lower voter participation among retail holders, issuers should determine whether the adoption (or continued use) of e-proxy is in their best interests. Companies will need to weigh the anticipated pricing and administrative benefits offered by e-proxy against the potential risk of a failed director election (particularly in the face of a majority vote requirement) due to a likely decline in votes "for" their nominees from retail stockholders. Issuers who have elected to use e-proxy in previous years should not feel compelled to continue to use this approach if countervailing factors justify reverting to the traditional "full set" delivery model. The costs and burdens resulting from a failed director election may dwarf any benefits an issuer would otherwise realize by using e-proxy.

Include a "routine" proposal in the annual meeting agenda. Because a broker's discretionary vote on one routine matter counts for purposes of establishing a quorum as to all matters considered at a stockholder meeting, issuers should strongly consider including at least one routine item on their agendas. A proposal to ratify the selection of the issuer's independent registered accounting firm, which is commonly submitted to stockholders for approval at annual meetings, continues to qualify as "routine" under Rule 452.

Revisit whether to adopt (or continue to use) majority voting. A number of issuers adopted majority voting in director elections on the assumption that a large portion of their retail shares would continue to be voted in favor of management's nominees in future elections. With the potential loss of much of this support, these issuers may wish to reexamine whether majority voting continues to be the appropriate standard in light of their corporate governance goals and responsibilities to constituent stockholders. Companies currently using a plurality standard should give careful consideration to the amendment to Rule 452 prior to switching to majority voting or adopting a plurality-plus approach.

Develop a strategy to increase retail holder participation. To increase voter participation levels among retail holders at its 2010 annual meeting, an issuer may, for example, hire a proxy solicitor and prepare "educational" materials advising retail holders about the amendment to Rule 452 and its anticipated impact on director elections, as well as the OBO/NOBO system of street name ownership. Some companies may benefit by undertaking campaigns that actively encourage OBOs to become NOBOs in order to permit direct communication between the companies and their beneficial holders.

Consult regularly with key institutional stockholders. Because the amendment to Rule 452 is likely to give institutional stockholders a much greater role in the director nomination and election process, issuers should understand their key institutional stockholders' voting policies and practices and engage in a regular dialogue with their representatives. In many cases, these discussions will allow an issuer to determine how the institutions are likely to vote at the issuer's next annual meeting, which may give the issuer an indication of how much time, effort and expense it should expend contacting and educating retail holders and encouraging them to vote. In other cases, these meetings may offer issuers insight into how they can modify certain existing practices, or adopt new practices, to help secure a greater percentage of the institutional stockholder vote in favor of managements' nominees.

Develop and regularly review a director succession plan. Issuers are encouraged to implement and/or revisit their board succession plans in advance of the 2010 proxy season. Succession planning entails identifying and screening potential candidates for the board and board committees on an ongoing basis and developing procedures for appointing candidates to the board in the event one or more directors is required to resign on short notice, including as a result of a failed election. Some companies also may consider consulting with a director search firm now so that the firm has sufficient time to familiarize itself with the company's board and business and be positioned to recruit potential replacements quickly if the need arises.

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