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SEC Approves Amendment to NYSE Rule 452, Eliminating Broker Discretionary Voting in Uncontested Director Elections

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At an Open Meeting today, the Securities and Exchange Commission approved an amendment to New York Stock Exchange Rule 452, *Giving Proxies by Member Organizations*.¹ As a result, uncontested director elections held on or after January 1, 2010 will be considered “non-routine” for all U.S. public companies² other than those registered under the Investment Company Act of 1940, and brokers will be prohibited from voting on these matters without specific instructions from beneficial owners. The amended Rule applies to all voting by brokers who are members of the NYSE and is not limited to companies listed on the NYSE.

BACKGROUND

“The most fundamental way in which shareholders can ensure that directors remain accountable to them is through the director election process. The NYSE’s proposal is designed to help assure that voting rights for matters as critical as the election of directors are exercised by those with an economic interest in the company, rather than by brokers, thereby improving corporate governance and enhancing accountability.”
- Chairman Mary Schapiro,
July 1, 2009.

Rule 452 allows brokers to exercise discretionary voting on behalf of shareholders in all “routine” matters if brokers do not receive voting instructions from beneficial owners at least 10 days before a company’s scheduled shareholder meeting. Prior to today’s amendment, the Rule categorized uncontested director elections as “routine”. The Rule was originally designed to help companies more easily establish a quorum and conduct business at shareholder meetings. Discretionary broker votes are most often cast on behalf of individual retail shareholders and typically follow managements’ recommendations, including for election of directors.

In 2005, the NYSE established a proxy working group consisting of companies, brokers, lawyers, institutional shareholders and other market constituents to examine proxy voting in general and broker discretionary voting in uncontested director elections in particular. Citing the authority that directors have “over the most fundamental issues of corporate governance” and “the critical role directors play in the life of a corporation”, the proxy working group recommended in its 2006 report that the election of directors should not be considered “routine” and that broker discretionary voting in uncontested director elections should not be permitted. The SEC explained today that the amendment is designed to enhance corporate governance and accountability by helping assure that shareholders with economic interest in the company vote on the election of directors and to address concerns that broker discretionary voting for directors has impacted election results.

The NYSE initially submitted a proposed amendment to Rule 452 to the SEC in 2006, but the required public comment process was not initiated until March 6, 2009, approximately

¹ The SEC also voted to codify two previously published interpretations under Rule 452 that do not permit broker discretionary voting for material amendments to investment advisory contracts with an investment company. In addition, the SEC today also voted to propose (1) amendments to rules relating to proxy disclosure and solicitations (please see our client memo entitled “SEC Proposes Proxy Disclosure Enhancements”), (2) clarifying amendments to the proxy solicitation rules and (3) new rules relating to shareholder approval of executive compensation of TARP recipients.

² This change will generally not impact foreign companies listed in the U.S. because Rule 452 already treats solicitations using proxy statements that are not comparable to those required under the U.S. proxy rules as “non-routine”.

one month after Chairman Mary Schapiro started her term. Stock exchange rules are normally approved by the SEC Staff, but in this case there was full Commission consideration. The Commission vote was split 3-2 along the same lines as its vote on proposed shareholder proxy “access” in May. Chairman Schapiro and Commissioners Aguilar and Walter voted in favor of the amendment, while Commissioners Casey and Paredes voted against. All five Commissioners noted a number of concerns about the implementation of the new rule and the need to address shareholder communications and other proxy voting issues. Chairman Schapiro noted that the Commission would be studying these “proxy plumbing” issues this year.

IMPACT OF TODAY’S AMENDMENT

Lower retail vote with corresponding shift of voting power to institutional shareholders and increase in influence of proxy advisory firms.

According to a Broadridge analysis of the 2009 proxy season, brokers on average exercised voting discretion over approximately 18.1%³ of the shares processed through Broadridge. As noted above, uninstructed shares are typically held by retail shareholders who often do not provide voting instructions to their brokers. Consequently, today’s amendment will likely result in a potentially significant decrease in voting by retail shareholders and a proportionate increase in the voting power of institutional shareholders. This increase in institutional shareholder voting power also will elevate the influence of proxy advisory firms to the extent that institutional shareholders rely on proxy advisory firms’ recommendations.

Companies with majority voting provisions or facing “vote no” campaigns may find election of directors more difficult.

For companies with majority voting in uncontested director elections, today’s change effectively eliminates a bloc of votes that historically has helped director nominees achieve majority votes. Without these votes, companies subject to majority voting may have difficulty electing directors, especially those companies that historically have had a high percentage of retail ownership. Shareholder activists’ and special interest groups’ “vote no” campaigns against directors also are likely to be more effective.

Continued use of e-proxy notice and access provisions may result in even lower levels of retail voting.

A June 2008 Broadridge survey showed that the 653 companies that elected to use e-proxy during the 2008 proxy season saw a 52% drop in total instructed retail votes cast compared to the prior season. Despite the drop in instructed retail votes, the uninstructed shares were still largely voted by brokers exercising their discretion on “routine” matters. After today’s amendment, those shares will no longer be voted in uncontested director elections. This could be of particular concern to companies in the context of majority voting requirements and “vote no” campaigns.

Difficulties faced by companies in communicating directly with beneficial owners of shares under existing rules will become more significant.

Under the SEC rules, companies only have access to the names and addresses of beneficial owners who hold their shares in “street name” if the beneficial owners do not elect to withhold their identities (Non-Objecting Beneficial Owners, or “NOBOs”). Approximately 70-80% of all public companies’ shares are held in “street name”, but NOBOs represent only approximately 25% of the shares held in “street name”. Thus, companies are unable to directly communicate with the owners of approximately 50-60% of their outstanding shares (Objecting Beneficial Owners, or “OBOs”), making it difficult for companies to conduct outreach to these shareholders and encourage them to vote.

Increased costs to solicit proxies.

After today’s amendment, companies will likely incur higher costs to solicit proxies, particularly if they have majority voting provisions or if they are trying to defend against “vote no” campaigns. Engaging proxy solicitation firms to help reach more shareholders, accelerating the proxy statement preparation process to allow for greater time to solicit proxies in advance of shareholder meetings and issuing supplemental proxy materials to follow up with shareholders all will increase the cost of soliciting proxies.

Achieving a quorum might be more difficult.

After today’s amendment, achieving a quorum might be more difficult for some companies. A vote on just one “routine” matter results in broker discretionary votes counting towards a quorum. But with uncontested elections now no longer considered “routine”, if a company does not include some other “routine” matter on its shareholder meeting agenda, sufficient votes to

³ Represents the level of broker discretionary voting processed by Broadridge at public companies, the shares of which are held in 300,000 shareholder accounts or more.

achieve a quorum might not be present. However, this problem will likely be limited to a few companies as most companies regularly have at least one “routine” matter, such as the ratification of the appointment of the company’s auditors, on the agenda for their shareholder meetings.

RECOMMENDED ACTIONS

Increased shareholder education was recognized by all the Commissioners as an important and necessary companion to today’s amendment. Specifically, the SEC Staff explained that they envision investor education efforts by a subcommittee of the NYSE proxy working group, supported by the SEC’s Office of Investor Education. In addition, the SEC Staff anticipate that companies will engage in their own outreach efforts to shareholders. It will be incumbent upon companies to make a more concerted effort to communicate with and educate their shareholders, primarily their retail shareholders, regarding director elections if companies are to maintain historical levels of voting participation. This need will be particularly acute for companies that have majority vote provisions or that are facing “vote no” campaigns.

Companies may wish to consider taking the following actions:

- educating shareholders about the change in the rules and the importance of their votes
- reconsidering the use of the notice and access model under the e-proxy rules, including increased use of mailing to retail holders
- preparing and mailing proxy materials as early as possible to ensure ample time for materials to reach beneficial owners from the brokers’ clearing houses
- engaging a proxy solicitor to conduct direct outreach to NOBOs
- where appropriate, preparing supplemental proxy materials and following up with shareholders to ensure maximum participation

LOOKING AHEAD

The vote to approve today’s amendment to Rule 452, almost three years after the NYSE submitted its initial draft amendment to the SEC and yet only six months after Chairman Schapiro’s term began, shows Chairman Schapiro’s commitment to move quickly and demonstrate progress on matters relating to corporate governance and accountability. This second 3-2 vote (following the SEC’s recent 3-2 vote to propose shareholder proxy “access” rules) also demonstrates Chairman Schapiro’s willingness to move forward on these issues even without consensus.

This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.

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