

DISCRETIONARY VOTING BY BROKERS PROHIBITED IN DIRECTOR ELECTIONS

Last week, in a controversial 3-2 vote, the Securities and Exchange Commission (the “SEC”) approved amendments to New York Stock Exchange (“NYSE”) Rule 452 that will prohibit discretionary voting by brokers in the election of corporate directors.¹ The amendment, which was originally proposed in 2006, continues the current regulatory trend towards granting increased influence to public shareholders, particularly with respect to the election of directors.²

The prohibition on discretionary voting for directors by brokers will apply to all brokers registered with the NYSE, and thus will affect all public companies, whether or not listed on the NYSE, except for companies registered under the Investment Company Act of 1940. The amended rule applies to all elections for directors, whether contested or not, at shareholder meetings held on or after January 1, 2010.

Background — Broker Discretionary Voting Today

Under current NYSE and SEC proxy rules, brokers who hold shares for their customers must deliver proxy materials to the beneficial owners of the shares and request voting instructions from them. If the beneficial owner does not provide the broker with voting instructions at least ten days prior to the election, NYSE Rule 452 allows the broker to vote the beneficial owner’s “uninstructed” shares on “routine” matters. Under Rule 452, “routine” matters include items such as ratification of the company’s independent auditors and, prior to the rule’s amendment, the uncontested election of directors.

Discretionary voting of uninstructed shares has become increasingly significant in light of the large proportion of public companies’ shares that are now held in “street name” and the fact that brokers tend to vote in accordance with management’s recommendations. For example, in recent years the NYSE’s interpretation of a “contested election” has been called into question, as an increasing number of proxy campaigns have targeted management nominees through “just vote no” or “withhold” campaigns that do not present a competing slate. Since these campaigns do not fall within the NYSE’s definition of a “contested election,” Rule 452 has worked to undermine them by increasing the vote in favor of the challenged directors.

¹ See Securities Exchange Act of 1934 Release No. 60215 (July 1, 2009), available at <http://www.sec.gov/rules/sro/nyse.shtml>. The SEC also proposed to codify two previously published NYSE interpretations that do not permit broker discretionary voting for material amendments to investment advisory contracts with an investment company or to contracts with new investment advisors.

² See *SEC Proposes “Proxy Access” Rules to Facilitate Director Nominations by Shareholders*, Willkie Farr & Gallagher LLP Client Memorandum, June 23, 2009; see also *The SEC’s Proposed “Proxy Access” Rules: Boon to “Accidental” or “Reluctant” Activists?*, Willkie Farr & Gallagher LLP Client Memorandum, June 30, 2009.

The Amendment and its Effect

By approving this amendment to NYSE Rule 452, the SEC has sided with the view that the election of directors, even if uncontested, is too important to be considered “routine” and should no longer be subject to discretionary voting by brokers. Specifically, the amendment will add the election of directors to the list of 18 enumerated items in NYSE Rule 452 for which a broker may not give a proxy to vote without instructions from the beneficial owner. The SEC believes that the amendment will enhance corporate governance by ensuring that directors remain accountable to shareholders through a more transparent election process.

- *Increased Influence of Institutional Shareholders and Proxy Advisory Firms.* Given the relatively low participation rate of retail shareholders in company elections, the amended rule will give greater influence to institutional investors and the proxy advisory firms that advise them, and may empower special interest groups holding relatively small blocks of shares. Under the amended rule, campaigns to withhold votes from directors who run unopposed, whether resulting from the recommendations of proxy advisory firms or initiated by activist shareholders or special interest groups, no longer will be undermined by discretionary votes of uninstructed shares by brokers, who typically vote for management’s slate of directors. The influence of these constituencies may be further amplified by the fact that the historically low retail shareholder participation rate has further decreased in the wake of the SEC’s recent notice and access (“e-proxy”) rules.³
- *Increased Cost of Obtaining Quorum.* The relatively low participation rate by retail shareholders will likely make it more difficult for companies to obtain the required quorum to elect directors. To counteract this effect, companies may need to spend more on proxy solicitation efforts in order to communicate with beneficial owners and encourage them to participate in director elections and to support board-nominated candidates. Smaller companies, which tend to have a higher proportion of retail shareholders, will likely feel the effects of the amended rule more acutely, having to expend a disproportionate amount of additional resources to solicit votes and obtain a quorum. To help ensure that they meet quorum requirements, companies should include on their meeting agendas at least one routine item (such as ratification of the company’s auditors) on which brokers continue to be permitted to give discretionary proxies.
- *Effect on Majority-Vote Companies.* In recent years, there has been a trend toward implementing “majority vote” structures for the election of directors. Although implemented in various ways, these structures typically provide that if a director nominee does not receive a majority of the votes cast for his or her election, the nominee either is not validly elected or is required to resign or offer his or her resignation to the company. Without broker discretionary votes, companies with such majority vote structures may find it more difficult to garner the requisite majority support for their director nominees.

³ In light of the amendment of NYSE Rule 452, companies should carefully consider the advisability of utilizing the SEC’s e-proxy rules rather than physically mailing paper copies of their proxy materials to shareholders.

Looking Forward

The changes to NYSE Rule 452 are likely to have a significant effect on the election of corporate directors and on corporate governance. Given the low retail shareholder participation rate in company elections, public companies will need to focus their efforts and resources on educating their shareholders on the proxy process and encouraging them to vote, particularly if they have majority voting requirements for the election of directors. In addition, “just vote no” or “withhold” campaigns are likely to become more successful, giving unhappy shareholders a more effective option for sending a “message” to companies at relatively low cost.

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