

Client Advisory | July 2009

## Broker Discretionary Voting for Directors Eliminated – Smaller Companies Will Need to Work Harder for the Retail Vote

Responding to concerns voiced by shareholder activists and others, the Securities and Exchange Commission has approved a rule change by the New York Stock Exchange that eliminates broker discretionary voting in uncontested elections for directors. This is expected to strengthen the hand of institutional shareholders, especially at companies that have adopted a majority vote requirement for electing directors, and it may also make it more difficult for a company with a substantial retail shareholder base to achieve a quorum for the annual meeting. The change applies generally to shareholder meetings beginning in 2010. Public companies – especially smaller ones – need to plan ahead for their next annual meeting to ensure that they can achieve their goals.



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### Current Practices

SEC and stock exchange rules require brokerage firms holding shares in “street name” to solicit instructions from account holders – the beneficial owners of the shares – on the voting of their shares at a shareholder meeting. If a beneficial owner does not respond, New York Stock Exchange Rule 452 allows the broker to vote the shares in its discretion at the meeting.<sup>1</sup> This does not apply to “contested” matters, including director election contests, or matters that the NYSE deems particularly significant, such as the approval of a material acquisition, preferred stock or an equity compensation plan. On those, the broker cannot vote unless it has received voting instructions from the beneficial owner.<sup>2</sup>

This means that virtually all shares held in street name are voted on “routine” matters, including most elections. Although they have discretion, brokers have no fiduciary obligation to weigh the beneficial owners’ best interests in voting. Historically, most have simply voted uninstructed shares in accordance with management’s recommendations. Since a large portion of all U.S. public company shares are held

in street name, and a very large portion of retail shareholders do not provide voting instructions without a proactive solicitation, this has provided a substantial level of support to incumbent management over the years. Shareholder activists and some institutional shareholders object strongly to this system, arguing that it perverts shareholder “democracy.” Broker discretionary voting is seen as hampering campaigns to “withhold” votes in director elections and other anti-management proposals that are not considered “contested” under NYSE Rule 452.

One recent development has mitigated these concerns somewhat. Many larger brokers holding shares in street name have used “proportional voting” for the past two proxy seasons. Under this approach, uninstructed shares are voted for and against any uncontested matter in the same respective proportions as instructed shares.

Whatever one’s views on the shareholder democracy issue, the current system provides one unarguable benefit. Virtually all shares held in street name are “present” at each annual meeting to be voted (whether instructed or discretionary) on the election

of directors. Accordingly, they contribute to the presence of a quorum that enables the meeting to occur.

### The Rule Change

The NYSE proposed and, on July 1, 2009, the SEC approved, amending Rule 452 to add all director elections to the list of matters on which brokers may not vote uninstructed shares in their discretion.<sup>3</sup> (The NYSE did not go so far as to eliminate all discretionary broker voting, as some have suggested.) The change is effective for shareholder meetings held after December 31, 2009, except those that were originally scheduled for 2009 but are adjourned into the new year. The change will not apply to elections of investment company directors.

### How Companies Should Respond

The larger a proportion of retail shareholders a company has, the more it will be affected by the loss of discretionary votes. Institutional investors generally vote, many of them because of regulators' views of their fiduciary responsibilities. In any event most institutional investors hold their shares at banks that do not vote uninstructed shares. Investor Relations personnel should consider educating shareholders about the importance of voting. Particular matters for a company to address include:

- **Achieving a Quorum.** Companies for whom the broker discretionary vote makes up a particularly large portion of votes cast should consider including an agenda item on which brokers may still vote in their discretion, if one is not already planned.<sup>4</sup> An obvious and easy one is ratification of the auditors (which may be a non-binding vote). Even though the uninstructed shares will be broker non-votes on the election of directors, they will be voted on the discretionary matter and thus present for quorum purposes.
- **Obtaining a Majority Vote for Directors.** Companies that require a majority vote for election of directors (or require any director who does not achieve a majority in a plurality vote to tender his or her resignation) need to enhance their solicitation strategy.<sup>5</sup> No longer may the company rely on the broker discretionary vote to achieve the majority. Companies will need to educate share-

holders about the importance of voting, and they may well need to use a professional proxy solicitor to ensure that a sufficient number of shares are voted for the director nominees.

- **Impact on Withhold Campaigns and Contested Matters.** It is generally believed that the Rule change will enhance the chance of success for withhold campaigns and other shareholder proposals opposed by management. Ironically, the termination of proportional voting may actually have a negative effect. With proportional voting, the total Withhold and Against votes are increased on the same basis as For votes, so discretionary proportional voting helps the proponents as well as management. The actual impact would depend on the proportion of shareholders who actually voted either way. Time will tell how the elimination of discretionary voting will affect shareholder proposals, but shareholder education and more energetic proxy solicitation will be necessary for companies to be confident of success.
- **Reconsider Your E-Proxy Strategy.** For companies that have a substantial retail shareholder base, the change to Rule 452 provides a reason to forgo the "Notice Only" alternative under the SEC's recent "E-proxy" rules. Experience has shown that voting by retail holders of record has dropped off substantially at companies that use the Notice Only option. With brokers unable to vote in their discretion, the similarly low response rate of retail beneficial owners will now exacerbate the problem. Also (in large part because Broadridge has added new processing fees), smaller companies have seen little or no cost savings from the Notice Only approach. These companies may well decide to use the "Full Set" alternative as part of the strategy for maximizing retail voter production.
- **Review Your Antitakeover Defenses.** The increased leverage of activist investors as a result of the NYSE Rule change and other recent changes to the proxy process should prompt companies to review their advance notice bylaws and other structural defensive measures and take appropriate steps to protect the interests of long-term investors.

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The Rule change will alter the voting landscape significantly, and companies must plan ahead if they wish to have successful annual meetings. This is particularly important for any smaller company with a sizeable retail shareholder base.

1. NYSE rules apply to any broker that is a NYSE member, which includes the majority of street name holders, even though the shares being voted may be traded on NASDAQ or the OTCBB.
2. If the broker is also voting in its discretion on an uncontested matter, it will indicate on the proxy card that it is not able to vote the respective shares on the contested matter. This is a “broker non-vote.”
3. The NYSE proposal may be found at [www.sec.gov/rules/sro/nyse.shtml](http://www.sec.gov/rules/sro/nyse.shtml) (Rel. 34-60215, Jul. 1, 2009).
4. Under Delaware law, broker non-votes are counted as “present” for quorum purposes, but in practice brokers don’t even submit a proxy for uninstructed shares if the only agenda item is one on which discretionary voting is not permitted.
5. Companies with these provisions should make sure that the required majority is of the votes cast in the election, not the total shares outstanding. In the latter case, not only will there be no broker discretionary vote “For” a director, but the broker non-votes would count as votes “Against” the director.

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