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Implications Of Amending NYSE Rule 452

Law360, New York (July 16, 2009) -- On July 1, 2009, the U.S. Securities and Exchange Commission, by a 3 to 2 vote, approved an amendment to New York Stock Exchange Rule 452 that will prohibit the exchange's member brokers from providing a proxy to vote on behalf of a beneficial owner holding voting shares in "street name" on the election of directors unless the broker receives instructions on the election proposal from the beneficial holder.

This change eliminates "discretionary voting" for all director elections.

Broker discretion has typically been exercised in favor of management's slate of directors in uncontested director elections, although there has been a recent shift toward proportional voting in which brokers exercise discretion on a proportional basis consistent with directed votes.

Contested elections are already considered "nonroutine" matters on which discretionary voting is not allowed.

The change to Rule 452 applies to NYSE member brokers and, accordingly, will affect meetings of shareholders of all operating companies listed on all U.S. stock exchanges, including the NYSE, the American Stock Exchange and the Nasdaq Stock Market. The meetings of registered investment companies are exempted from the rule change.

Approval of the amendment of Rule 452 by the SEC will likely have a substantial effect on corporate governance generally and specific circumstances in which technically uncontested elections are nonetheless the subject of shareholder activism. The amended Rule 452 is applicable for shareholder meetings held after Dec. 31, 2009.

Majority Voting

Director “vote-no” or “withhold” campaigns have been an increasingly common means by which activist shareholder groups, such as labor unions and pension funds, signal disapproval of individual director nominees or board performance generally or with respect to particular issues, such as a company’s executive compensation practices.

Until recently, plurality voting for directors, under which a director need receive only one vote in an uncontested election to be elected, was the nearly universal standard for director elections of public companies in the United States.

Majority voting policies or bylaw provisions championed by shareholder activists have become increasingly common.

Under the majority voting standard, a director in an uncontested election is required to offer his or her resignation (which resignation, depending on the wording of the policy or bylaw, may be “conditional” and subject to board acceptance in the board’s discretion) if he or she does not receive a majority of “FOR” votes.

In relatively few cases where majority voting standards require not just a majority of the votes cast, but that director nominees receive favorable votes of 50 percent of the outstanding shares, the impact of the rule change will be most significant.

Companies with large numbers of retail shareholders have relied heavily on discretionary voting to re-elect directors in uncontested elections.

In a comment letter on the rule change submitted to the SEC, the Society of Corporate Secretaries & Governance Professionals noted that since the issuance of the report and recommendations of the NYSE Proxy Working Group on June 5, 2006, at least 10 of the largest retail brokers have instituted proportional discretionary voting policies, pursuant to which discretionary votes are cast in proportion to instructed retail votes.

Broadridge Financial Services Inc. (formerly, ADP) estimates that in 2007, 98 percent of retail shareholder voters who did provide voting instructions supported the board nominees in director elections, and it has also been common for brokers who do not observe proportional voting policies to vote with the recommendations of the board.

Because proportional voting is an exercise of discretionary voting, the change to Rule 452 will end these practices.

Consequently, stripping brokers’ ability to increase the number of “FOR” votes for directors in the name of retail shareholders could result in fewer votes for director nominees in uncontested elections and more director resignations, whether or not conditional, required by majority voting policies and bylaw provisions.

Increased Influence of Institutional Investors and Proxy Advisory Firms

Because most brokers either vote in proportion to instructed retail votes or in accordance with management recommendations, opponents of the rule change argued that broker discretionary voting is a vehicle that gives a voice to retail shareholders that otherwise would not be heard at shareholder meetings.

By eliminating broker discretionary voting, institutional investors, including hedge funds, will comprise a much higher proportion of the votes cast and therefore enjoy increased influence on election of directors.

In addition, many institutional investors rely on the proxy advisory firms, such as RiskMetrics Group Inc., Glass Lewis & Co. and Proxy Governance Inc., for voting recommendations. The rule change will likely increase the growth and voting power of these advisory firms.

Quorum Requirements

Discretionary voting plays a key role in the achievement of a quorum for the conduct of business at most shareholder meetings.

The amendment means that most issuers will need to be sure they include at least one “routine” proposal for their shareholder meeting in order to obtain a quorum of voting securities represented by proxy or in person in order to conduct the meeting.

Traditionally the one other proposal that has most uniformly been seen as routine is the ratification of the selection of auditors, although this characterization has been challenged in the past and might be again.

Proposed Additional Disclosures Regarding Compensation and Governance

At its July 1, 2009, meeting, the SEC also voted unanimously to issue for comment proposed changes to its disclosure rules regarding certain compensation and corporate governance matters and clarifications to its rules governing proxy solicitations.

Additional required disclosures would include the following new or enhanced information:

- Analysis in the compensation discussion and analysis section of the proxy statement about how a company’s overall compensation policies (not limited to those applicable to executives) create incentives that can affect a company’s risk, and the management of that risk.

Disclosure would only be required if the risks arising from the compensation policies may have a material effect on the company.

- A description of the board's role in the company's risk management process
- More information about the qualifications of directors and nominees, including the particular experience, qualifications, attributes or skills that qualify that person to serve as a director of the company or as a member of a board committee.

In addition the proposed amendments would require companies to disclose any directorships held by each director nominee at any public company during the previous five years.

- A discussion about the company's leadership structure, including why the company believes a particular structure is best for the company. Companies would also have to disclose whether and why they have chosen to combine or separate the chair and CEO positions.
- Disclosure about services performed and fees paid to compensation consultants when the consultants provide services to the company in addition to providing advice used by the company in determining the amount or form of compensation for executives and directors.

The commission also voted to revise the way in which stock and stock awards to named executive officers and directors are reported in the compensation tables of the proxy statement so that the reporting of such awards is based on their fair value on the date of grant rather than the value recognized annually for financial statement purposes.

In addition, the SEC voted to propose a new rule to require a company to report the voting results from a shareholder meeting within four business days on a Form 8-K and several amendments to the proxy solicitation process.

Further Increases in Corporate Governance Regulation

The amendment to NYSE Rule 452, together with the proposed changes to the SEC's disclosure rules noted above and several additional proposed and enacted regulatory changes summarized below, cumulatively portend a significant shift in the complex mosaic of federal and state regulation of corporate governance and, consequently, the balance of power between management and shareholders.

Last May, by a 3-2 vote, the SEC voted to issue a proposal to change the federal proxy rules to facilitate director nominations by shareholders.

The proposed new provisions would permit a shareholder or shareholder group with a significant holding in the company to propose nominees for the greater of one seat or 25 percent of the seats available on the board at the annual shareholders meeting.

Nominees proposed by shareholders would be included in the company's proxy materials alongside management's proposed slate of director nominees.

Earlier, in April, Delaware enacted amendments effective Aug. 1, 2009, to the Delaware General Corporation Law that enable a private-ordering approach to proxy access. The amendments expressly authorize, but do not require, the adoption of bylaws providing for proxy access.

Rather than prescribe the terms of access, such as minimum levels and duration of share ownership, the revised Delaware statute would permit companies to fashion their own manner of providing proxy access if they chose to do anything in that regard.

If the SEC's proxy access proposals are adopted as issued, the federal rules would likely limit what Delaware companies could adopt on their own with respect to proxy access under the state statute.

Several bills are pending in Congress that would mandate significant changes to governance and compensation practices and disclosure.

Among them is a bill introduced by New York Senator Charles Schumer entitled the "Shareholder Bill of Rights Act of 2009," which includes provisions requiring the SEC to adopt proxy access rules and requiring public companies to allow shareholders a "say on pay" advisory vote on the company's executive compensation, and two bills introduced by Sen. Richard Durbin, D-Ill., aimed at curbing "excessive" compensation: the "Excessive Pay Shareholder Approval Act" and the "Excessive Pay Capped Deduction Act of 2009."

Recommended Actions for Public Companies

Public companies should consider taking the following steps in preparation for the 2010 proxy season given the change to Rule 452 and the possibility of additional new regulation:

- Evaluate possible issues with the company's governance practices under the various proxy advisory firm guidelines and specifically consider the board's risk profile for potential "vote no" or "withhold" campaigns.
- Consider impact on expected management and shareholder proposals in 2010.
- Reevaluate existing majority voting policies or bylaw provisions if applicable.
- Consider the voting thresholds and consequences of failing to meet those thresholds when determining how best to communicate with shareholders.

- Review annual meeting bylaw and policy provisions and consider possible amendments to provisions such as quorum, meeting adjournment, advance notice, contested director elections, terms of directors and director resignations.
- Study the company's shareholder profile with input from a proxy solicitor, not only how much of the voting stock is held by retail shareholders, but also how many of those votes have been executed by brokers in the past, to what extent proportional voting has been used and how reliant the company has been on such votes to achieve quorum and majority voting thresholds.
- Develop an action plan to educate shareholders and consider new methods of communication. Participation by retail shareholders in the future will depend on ensuring that those shareholders understand the increased importance of their vote and have the means to efficiently participate.
- If your shareholder profile is largely comprised of institutional investors that utilize proxy advisory firms, it will be increasingly important to maintain consistent communication with those firms and provide detailed information on shareholder proposals. Approval of proxy advisory firms will become even more critical in the event of declining retail shareholder participation.
- Evaluate the potential first use of electronic delivery of proxy materials under the SEC's "notice and access" rules or, if applicable, changes to prior use (e.g., altering any stratification of varying means of delivery).
- Prepare contingency plan in the event that a failed election is reasonably foreseeable.
- Plan to include auditor ratification vote to ensure quorum for annual meeting.
- Keep up to date on emerging legislation and SEC rulemaking on proxy access, "say on pay," and governance and compensation disclosure.
- Educate board and senior management of potential significance of the enacted and pending rule changes.

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