SIMPSON THACHER MEMORANDUM

SEC Acts to Eliminate Broker Discretionary Voting in Director Elections

August 4, 2009

INTRODUCTION

Starting with the 2010 proxy season, brokers holding shares in street name on behalf of customers will be prohibited from voting those shares in director elections, including uncontested elections, unless the customers have given specific voting instructions to the brokers. Companies should plan now for the challenges this change will present for director elections at their 2010 annual meetings.

AMENDMENT SUMMARY

At the July 1, 2009 open meeting of the Securities and Exchange Commission, the Commissioners voted 3-2 to approve a proposal submitted by the New York Stock Exchange to amend NYSE Rule 452 and corresponding Section 402.08(B) of the NYSE Listed Company Manual to eliminate broker discretionary voting in director elections.[1] The change will apply to stockholder meetings held on or after January 1, 2010.[2] Because most large brokerage firms are NYSE member organizations, this change will affect companies listed not only on the NYSE but also those listed on other national securities exchanges such as NASDAQ.

Approximately 85% of exchange-traded securities in the United States are held in street name by intermediaries, such as brokers and banks, on behalf of their clients.[3] A broker that is a member of the NYSE and that is the record owner of shares held in street name on behalf of a beneficial owner may vote those shares on "routine" matters if the beneficial owner has not provided voting instructions at least 10 days before a meeting. The current NYSE rules specify 18 "non-routine" matters upon which brokers cannot cast a vote without instructions from the beneficial owner. Prior to the amendment, only contested director elections were included in the Rule 452 list of non-routine items upon which brokers could not vote uninstructed shares. The amendment expands the list of non-routine matters to include all director elections, regardless of whether they are contested.

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1 Exchange Act Release No. 60215 (July 1, 2009).

2 The amendment to Rule 452 will not apply to meetings that were scheduled to be held prior to January 1, 2010 but that were properly adjourned to a later date. The amendment will not affect meetings of companies, such as mutual funds, registered under the Investment Company Act of 1940. Rule 452 already prohibits broker discretionary voting on material amendments to investment advisory contracts and any proposal to obtain stockholder approval of an advisory contract with a new investment advisor. The change to Rule 452 does not impact foreign private issuers because they are not subject to United States proxy rules.

3 See Briefing Paper, Securities and Exchange Commission, Roundtable on Proxy Voting Mechanics (2007).

AMENDMENT BACKGROUND

In 2005, the NYSE formed a working group, known as the Proxy Working Group, to consider emerging issues related to proxy mechanics, focusing particularly on Rule 452. This group included representatives from listed companies, NYSE member organizations, lawyers and institutional and individual investors. After conducting this review and noting the important structural role that directors play in a corporation, the Proxy Working Group issued a report recommending that the uncontested election of directors be included among the items ineligible for broker discretionary voting under Rule 452. In 2006, the NYSE requested SEC approval of this change to Rule 452, and the SEC embarked upon a series of roundtable discussions about proxy issues.

In adopting the proposal, the SEC determined that the change to Rule 452 was reasonable and consistent with the Securities Exchange Act of 1934. Moreover, given the large proportion of stock held in street name, the importance of corporate governance and accountability as expressed through the election process and the concern that broker discretionary voting distorted election results, the SEC concluded that the rule change enfranchised stockholders by helping to assure that votes on issues critical to the operation of the corporation are decided by those with an economic interest in the entity.

FOCUS ON PROXY VOTING MECHANICS

At the July 1 open meeting, SEC Chairman Mary L. Schapiro underscored the importance of the proxy system when she stated that, "With over 800 billion shares being voted annually at over 7,000 company meetings, it is imperative that our proxy voting process work – starting with the quality of disclosure and continuing through the integrity of the vote results." Recent developments, such as the widespread adoption of majority voting standards for director elections, efforts to provide stockholders with access to company proxy materials to nominate directors and greater ease in separating voting rights from economic interests through derivative securities, have increased scrutiny of the proxy voting process. Although the need for comprehensive reform is widely acknowledged, the shape of that reform is the subject of contentious debate.[4]

[4] Troy A. Paredes, an SEC Commissioner who voted against the change to Rule 452, stated that, "A number of matters relating to shareholder voting have been discussed recently, such as e-proxy; company communications with shareholders; proportional voting and client directed voting; so-called 'over-voting' and 'empty voting'; and the role and influence of proxy advisory firms. Any consideration of Rule 452 would, in my view, benefit from the insights that flow from a more complete evaluation of the proxy process." Elisse B. Walter, an SEC Commissioner who voted in favor of the change, stated that the elimination of broker discretionary voting in director elections "must mark the beginning of a more in depth look into other 'proxy plumbing' issues like shareholder communications (or, the 'NOBO/OBO' distinction) as well as over and empty voting."

POTENTIAL CONSEQUENCES OF AMENDMENT TO RULE 452

1. Increased Costs for Companies to Achieve Quorum

The elimination of broker discretionary voting in director elections will likely reduce the number of shares voted by proxy. This is particularly true for mid-cap and smaller companies with a high proportion of retail stockholders, who traditionally have relatively low response rates to annual meeting solicitations.

Broker discretionary votes play a key role in the achievement of a quorum for the conduct of business at most stockholder meetings. The corporation laws of many states, including Delaware, provide that a quorum, once established for a meeting, is valid for all matters voted on at that meeting. As a result, the allowance of broker discretionary votes for routine matters can establish a quorum that is valid for the entire meeting, including non-routine matters. The elimination of uncontested elections removes one matter used by corporations to help reach a quorum, leaving the ratification of auditors as the only customary routine matter for stockholder voting. If there are no routine matters on the agenda, companies may have trouble establishing a quorum without engaging a proxy solicitor and incurring the high costs of campaign-like efforts, such as targeted phone calls and colorful mailings to be filed as additional soliciting materials, to encourage retail stockholders to give brokers voting instructions.

2. Reduction in the Use of the Notice Only Option Under the E-Proxy Rules

The change to Rule 452 may discourage companies, particularly those with high retail stockholder bases, from taking advantage of "notice and access" electronic delivery of proxy materials, sometimes referred to as e-proxy. Voting by retail investors has declined significantly at companies implementing electronic delivery of proxy materials. Because the inability of brokers to vote uninstructed shares in director elections makes retail stockholder participation more important than ever, companies may be reluctant to rely solely on electronic delivery of proxy materials and may be incentivized to retain or return to traditional paper mailings under the "full set delivery" option, thereby foregoing the substantial cost savings and environmental benefits available under the "notice only" option.

3. Increased Difficulty in Obtaining Majority Support in Director Elections

Majority voting requirements for director elections are becoming increasingly common in the United States. According to a Corporate Library report, as of December 2008, 49.5% of S&P 500 companies had adopted majority voting in director elections and another 18.4% had retained a plurality standard but adopted a policy requiring the resignation of a director not receiving majority support.

Without the benefit of broker discretionary voting, it is more difficult for directors to accumulate the necessary votes to achieve majority support. Companies considering the

adoption of majority voting provisions may have second thoughts, and companies that have already adopted such provisions will be more vulnerable if they are targeted by "vote no" campaigns.

4. Rise in Influence of Third Parties

The elimination of broker discretionary votes in director elections enhances the influence of the stockholders who do cast votes. In particular, due to the lower rate of retail stockholder participation, the elimination of broker discretionary voting in director elections may give disproportionate weight to the votes of institutional investors, which may be substantially swayed by the recommendations of proxy advisory firms, or holders of blocs of shares, such as hedge funds, that may favor narrow interests. This will further strengthen the influence of proxy advisory firms such as RiskMetrics Group, Inc., Glass, Lewis & Co. and PROXY Governance, Inc.

One of the SEC's objections to broker discretionary voting is that it allows voting decisions to be made by entities that do not have an economic interest in the company.[5] The same criticism could be leveled against proxy advisory firms, which are not subject to regulatory oversight or requirements to disclose conflicts of interest. Common triggers for "vote no" or "withhold" recommendations from proxy advisory firms include:

- failure to implement a stockholder proposal that obtained majority support;
- lack of independent directors on the board or on key board committees;
- use of controversial compensation practices such as gross-ups and golden parachutes;
- directors serving on the boards of too many companies at the same time; and
- the adoption of a poison pill without stockholder approval.

5. Disputed Impact on Enfranchisement of Beneficial Owners

There is some disagreement about whether the change to Rule 452 enfranchises beneficial owners by preventing brokers from speaking for them unless they speak for themselves in director elections or whether it disenfranchises beneficial owners by altogether eliminating the impact of their shares in director elections. When taking discretionary votes on routine matters, brokers have historically supported positions recommended by management. Some argue that, because retail stockholders tend to follow management recommendations when they actually do give voting instructions, allowing brokers to cast discretionary votes with uninstructed

[5] This objection potentially has broader implications given the increasing disconnect between share ownership, voting power and economic exposure that derivative securities can create.

shares actually provides a means for expression of retail stockholder preferences. The elimination of these votes enhances the influence of votes by institutional investors and magnifies the importance of proxy advisory services.

In recent years, many brokers have adopted proportional voting, in which the broker votes uninstructed shares on routine matters in the same proportion as shares that were instructed. One way to mitigate any disenfranchising impact of the change to Rule 452 would be for brokers to adopt "client directed voting" in which beneficial owners give brokers standing instructions about how to vote their shares (e.g., in accordance with the recommendations of management unless otherwise instructed by the beneficial owner on a particular matter). Client directed voting would still require some action by beneficial owners, but it would be required only once rather than each year for each company in the beneficial owner's portfolio.

6. Additional Pressure on Company Communications with Stockholders

The change to Rule 452 exacerbates problems arising from the inability of companies to communicate with their stockholders. When an investor opens a brokerage account with an intermediary, the investor specifies whether it wishes to be treated as an objecting beneficial owner (OBO) or a non-objecting beneficial owner (NOBO). Intermediaries are not permitted to provide companies with the names and addresses of OBOs.

Because the identities of OBOs are confidential, issuers must communicate with them through intermediaries rather than directly. Companies may have difficulty communicating with OBOs who hold shares in street name and have not consented to allow brokers to release their names and addresses to the companies. Since the change to Rule 452 was not coupled with mechanisms for companies to communicate directly with OBOs, intermediaries will become an even more important conduit for communications from companies to OBOs as companies strive to maintain the retail vote that has historically supported the companies' director nominees.

RECOMMENDATIONS

Well before the 2010 proxy season commences, companies should consider the likely impact of the elimination of broker discretionary voting on their director elections and plan accordingly. Depending upon their particular circumstances, companies may wish to undertake some of the following action items:

- Analyze the company's stockholder profile, historical voting patterns and the impact of broker discretionary voting on past uncontested director elections.

- Consider amending company organizational documents to lower the threshold required for a quorum if permissible under applicable state corporation law.

- Consider adding auditor ratification or some other "routine" proposal to the 2010 annual meeting agenda and/or mailing proxy materials earlier than usual in advance of the meeting to ensure that a quorum will be achieved.
- If there are no routine proposals on the agenda, evaluate the advisability of hiring a proxy solicitor.
- Assess the likelihood of company directors becoming targets of a "vote no" campaign – perhaps as the result of a negative recommendation from a proxy advisory firm.
- Consider whether corporate action could be taken prior to the next annual meeting to avert a "vote no" campaign. Publicize any such change through a press release or by filing a Form 8-K or additional definitive proxy materials with the SEC.
- Prepare legal and public relations contingency strategies for implementation if a director does not obtain a majority vote.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

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