March 26, 2009

Corporate Governance Update: Activist Shareholders Would Gain Power from Proposed Rule Change

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Recently, a number of corporate governance reforms have been proposed or undertaken at the stock exchanges, as well as at the state and federal level, that may, when taken together, have profound consequences for director elections and the power of institutional investors and activist shareholders. One such reform is the New York Stock Exchange's (NYSE) proposed rule,[1] recently resubmitted to the Securities and Exchange Commission (SEC), that would prohibit discretionary voting by brokers in uncontested director elections. This proposed reform should be considered in the context of a rapidly shifting corporate governance environment, in part driven by political pressures arising from the current economic environment, which increasingly features majority voting and the electronic dissemination of shareholder materials, as well as in light of recently proposed changes to the Delaware General Corporation Law (DGCL).[2] When considered in this context, the proposed NYSE rule change could significantly increase the power of institutional shareholders generally and activist shareholders specifically in influencing director elections and corporate affairs.

Proposed Change to NYSE Rule 452

Under current NYSE and SEC rules, brokers must deliver proxy materials to beneficial owners in advance of a shareholder meeting, and must request instructions from each beneficial owner regarding how to vote such owner's shares at the upcoming meeting.[3] The current version of NYSE Rule 452 permits brokers to exercise discretionary voting authority with respect to shares for which voting instructions have not been received by the 10th day preceding the shareholder meeting (these shares are sometimes called "uninstructed shares"), but only for matters that the NYSE considers "routine".[4] Uncontested director elections have long been considered routine matters, thus allowing brokers to vote uninstructed shares in such elections. By contrast, in contested elections, which the NYSE defines as elections that are the subject of a

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[1] *See* SEC Release No. 34-59464 (Feb. 26, 2009) available at http://www.sec.gov/rules/sro/nyse/2009/34-59464.pdf.

[2] *See* House Bill #19, 145th Delaware General Assembly, "An Act To Amend Title 8 of The Delaware Code Relating To The General Corporation Law" available at http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19/$file/1901450379.doc?open. A summary of the House Bill is available at http://legis.delaware.gov/LIS/LIS145.NSF/vwlegislation/F97681D196D4872385257571004E64F1?open. The bill was adopted by the Delaware House of Representatives on March 18, 2009.

[3] The NYSE's proxy rules are found at Rules 450-460 and Rule 465. *See also* Securities Exchange Act Rule 14b-1.

[4] *See* NYSE Rule 452. Historically, on "routine" matters, brokers generally vote as recommended by management, including in the election of directors.

counter-solicitation or are part of a proposal that is being opposed by management,[5] brokers may not vote uninstructed shares.

On February 26, 2009, the NYSE resubmitted to the SEC a proposal to amend Rule 452 to provide that the election of directors is not a routine matter, meaning that brokers would not be permitted to cast uninstructed votes in any director election. The proposal was first advanced by the NYSE in October 2006 and reflected work of the Proxy Working Group that was created by the NYSE in April 2005, but the proposal was not approved by the SEC as it was then conducting a broader review of shareholder access issues.[6] The public comment period for the recently reproposed rule expires tomorrow.[7] If approved by the SEC prior to August 31, 2009, the amended rule would be applicable to proxy voting for shareholder meetings held on or after January 1, 2010. Because NYSE Rule 452 applies to brokers, the proposed amendment, if adopted, will impact not only issuers listed on the NYSE, but also issuers listed on other exchanges such as NASDAQ.[8]

The Proposed Rule Change in Context

While the change to NYSE Rule 452 may appear technical and may have been conceived with shareholder interests in mind, its consequences are likely to be far-reaching and detrimental to a significant group of shareholders. Particularly when considered alongside other recently implemented changes, the proposed NYSE rule change is likely to magnify the already significant influence of institutional investors, activist shareholders and proxy solicitation firms, further constraining boards of directors from exercising independent business judgment on behalf of all shareholders. For example, if a company has 1,000,000 outstanding shares, 70 percent of which are held by institutional shareholders and 30 percent of which are held by retail accounts, the 70 percent held by institutional shareholders is likely to be voted by the institutions, while historically, only a small portion of the retail shares will provide instructions regarding the vote. Thus, if two-thirds of the stock held by retail holders do not provide instructions to their broker as to how to vote, under the proposed rule change, brokers will not have the ability to vote those shares, effectively disenfranchising these retail holders with 200,000 shares while further enhancing the power of the institutions on any matters to be decided by a majority of the shares actually voting.

The risk of retail disenfranchisement is especially acute in view of evidence that the broker discretionary vote, while not perfect, reasonably accurately reflects the views of retail shareholders. In its comment letter to the SEC on the proposed NYSE rule change, the Society of Corporate Secretaries & Governance Professionals states that Broadridge Financial Solutions, Inc. estimated that more than 98 percent of retail shareholders who provided voting instructions

[5] NYSE Rule 452.11(2).

[6] "NYSE Kills Broker Vote Reform Amid SEC Action," Compliance Week (Oct. 2, 2007) (reporting that the NYSE emailed its listed companies stating that "Based on recent conversations with SEC staff members… we learned that our proposed rule filing is being considered by the Commission as part of a broader range of issues relating to shareholder communications and proxy access," and as a result, "our rule filing will not be approved for the 2008 proxy season.").

[7] As of yesterday, over 40 letters had been submitted to the SEC commenting on the proposed NYSE rule change. Over half of the comments submitted to date have included objections or criticisms of the proposed rule change.

[8] The amended rule would not be applicable to investment companies. *See* page 3 of the proposed amendment.

to their brokers in 2007 supported the boards' nominees for director.[9] The broker discretionary vote, even if cast in favor of incumbent directors as it historically has been, appears to represent the view of retail shareholders. What is more, many large brokers have recently instituted proportional voting policies in which they vote uninstructed shares in the same proportion as the actual retail vote, making the broker discretionary vote an even more accurate reflection of the views of these under-represented shareholders.[10] The current system appears to be generally working to represent smaller shareholders, and is improving further with the advent of proportional voting. The proposed NYSE rule change would bring a sudden halt to this process of improvement, to the detriment of smaller shareholders.

Research conducted by the NYSE in connection with its proposal showed that more than a quarter of shareholders who owned and traded stocks outside of an employer sponsored savings program assumed that their brokers would vote their shares in the absence of instructions, and that their brokers would generally vote such shares in accordance with the recommendation of management.[11] More than a third of those surveyed indicated awareness that if they do not vote their proxy on routine matters their shares may be voted by their broker in its discretion.[12] The proposed NYSE rule change would be contrary to the expectations of these shareholders. Moreover, while the proposed rule change would create an incentive for companies to communicate directly with shareholders, it is not always possible for a company to know the identity of the ultimate beneficial owners of its shares, due to the complexity of the stock ownership structure and current SEC rules preventing issuers from contacting certain shareholders.[13] The revised rule also may cause a problem for some companies in achieving a quorum for shareholder meetings dealing only with non-routine matters, since uninstructed shares may not count towards the quorum in these circumstances. Thus, companies would have to bear additional costs to make sure that a sufficient quorum is present.

At the same time, governance changes at many corporations could increase the potency of shareholder activism. For example, many companies recently have adopted bylaws providing for a majority voting standard in the election of directors.[14] A common formulation of the majority voting standard requires a director nominee to receive at least a majority of the number of votes cast with respect to that director's election in order to be elected to a board of directors, and requires an incumbent director to tender his or her resignation from the board of directors if

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[9] "Letter to SEC Re Proposed Amendment to New York Stock Exchange Rule 452 (Release No. 3459464; File No. SR-NYSE-2006-92)," Society of Corporate Secretaries and Governance Professionals, p. 2, March 20, 2009.

[10] *See* Letter of Corporate Secretaries & Governance Professionals, *supra* (stating that at least ten of the largest brokers, representing more than 40% of the market, have instituted proportional voting policies for voting uninstructed shares).

[11] *See* "Report and Recommendations of the Proxy Working Group to the New York Stock Exchange," p. 15 (June 6, 2006).

[12] *Id*. at fn. 23.

[13] Current SEC rules allow shareholders to choose whether or not they wish to have their names and addresses disclosed to issuers. *See* Securities Exchange Act Rule 14(b)-1.

[14] Based on Riskmetrics Group data, by year-end 2008, approximately 70 percent of S&P 500 companies had a majority voting or "plurality plus" standard (the latter being essentially a plurality requirement for director elections plus a policy requiring a director to submit his resignation if majority approval is not obtained). For further discussion of majority voting, please see our prior articles, including "Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes," New York Law Journal (Oct. 30, 2008).

this threshold is not met during re-election. Achieving these self-imposed thresholds would be more difficult when brokers are unable to vote shares for which they have not received voting instructions. This is particularly the case where an activist launches a "vote no" campaign, where the inability of brokers to vote absent specific instruction from the underlying retail holder would magnify the impact of the disaffected activists. Companies with majority voting standards may have difficulty attracting and retaining qualified directors, while companies that have not yet adopted such a standard may reconsider the merits of doing so.

The loss of the broker discretionary vote in uncontested director elections is also likely to increase further the influence of the voting recommendations of proxy advisory firms such as RiskMetrics Group, Inc., Glass Lewis & Co., LLC and Proxy Governance, Inc. on the outcome of director elections. Proxy advisory firms may issue more withhold or against vote recommendations for director nominees as they increase their scrutiny of corporate governance and executive compensation practices, and as the impact of such recommendations is heightened by the combination of majority voting standards and the proposed NYSE rule change.[15]

The NYSE's rule change proposal recognizes explicitly some of the potential problems for issuers that would result from the rule change:

> The Proxy Working Group report notes that this proposed change could significantly impact the director election process. For example, it is likely to increase the costs of uncontested elections, as issuers will have to spend more money and effort to reach shareholders who previously did not vote. These costs may increase substantially with the rise of majority voting for directors, as issuers have to obtain the votes from shareholders who may not realize that their failure to vote constitutes a "no" vote. Such a change may also increase the influence of special interest groups or others with a particular agenda to challenge an incumbent board, at the expense of smaller shareholders. These consequences could fall most dramatically on smaller issuers, who have a smaller proportion of institutional investors and/or have greater difficulty in contacting shareholders and convincing them to vote in uncontested elections.
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> . . . . While this is likely to result in some greater costs and difficulties for issuers, it is a cost required to be paid for better corporate governance and transparency of the election process. [16]

The proposed change to NYSE Rule 452 also should be considered in light of the SEC's new "e-proxy" rules, which allow companies to post proxy statements online and to direct their shareholders accordingly.[17] Companies that have taken advantage of these new rules have seen a significant drop in voting from smaller shareholders.[18] For such companies, the inability of

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[15] "Proposed NYSE and Delaware Law Change Could Facilitate Election of Activist Nominees to Boards of Directors," Georgeson Report (March 2, 2009).
[16] SEC Release No. 34-59464 at 6.
[17] *See* SEC Release No. 34-55146 (2007).
[18] "Notice & Access: Statistical Overview of Use with Beneficial Shareholders," Broadridge Financial Solutions, Inc. (June 30, 2008) (available at: http://www.broadridge.com/notice-and-access/NAStatsStory.pdf).

brokers to vote uninstructed shares would have an especially powerful impact in elevating the influence of institutional investors, activist shareholders and proxy advisory firms. Moreover, companies that have not yet taken advantage of the e-proxy rules understandably may be reluctant to do so if the consequence is increased exposure to special interests. At the same time, the monetary and resource savings of delivering proxy material electronically may be offset by the increased expense of companies' attempting to communicate with shareholders directly.

Delaware Amendments

It is important to understand that the proposed NYSE change would be implemented in a governance environment that is rapidly changing – not only at the SEC and company level but also at the state level – and that many of these changes are shifting or have already shifted substantial power toward institutions and activist investors. For example, the Delaware State Bar Association has proposed amendments to the DGCL that concern director elections, and that would become effective August 1, 2009.[19] One proposed amendment would expressly permit the adoption of a bylaw providing shareholder access to the company's proxy statement for the purpose of director elections. The proposal would allow for the imposition of conditions upon access, such as minimum stock ownership requirements, disclosure of stock ownership (including economic exposure through derivatives) and other disclosures. Another proposed amendment would permit the adoption of a bylaw to require the company to reimburse shareholders that have incurred expenses in connection with their solicitation of proxies for director elections (again, with a company able to impose reasonable conditions to the right of reimbursement). Bylaws permitted by the new legislation could be proposed and adopted by the shareholders or by corporate boards. These changes are an attempt to take action in an area in which the SEC has not yet acted and where, in the absence of state action, Congress or the SEC could choose to act in a potentially less focused manner. While it is appropriate that Delaware has taken action as it is individual states that rightfully legislate on such matters of corporate law, the proposed Delaware changes could nevertheless lower traditional barriers faced by activist shareholders in launching proxy solicitation campaigns, and further enhance the activist shareholder's toolkit.

Conclusion

The proposed changes to the NYSE rule regarding broker non-votes will increase the power of institutional investors and activist shareholders, at the same time as reforms such as majority voting, changes in state law and the "e-proxy" regime make it more challenging for boards of directors to weigh such powerful interests appropriately against the interests of all shareholders in their directorial judgment. It would be wise to give the initiatives already underway more time to develop before adding further changes and to consider new changes in a holistic manner in light of the reforms in place. While the NYSE rule proposal says that the change is necessary to promote "better corporate governance and transparency of the election process,"[20] it effectively will disenfranchise retail holders of securities while significantly increasing costs for issuers. There is a risk that the cumulative effect of the various reforms will be a dramatic shift in power toward institutional investors, activist shareholders and proxy

[19] *See* House Bill #19, 145th Delaware General Assembly, *supra*.
[20] SEC Release No. 34-59464 at 6.

advisory firms. The result could be boards of directors unduly focused upon placating the loudly-voiced demands of narrow interest groups, rather than upon exercising independent directorial business judgment on behalf of all shareholders.