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Hot Issues Alerts – Law Firms

SEC: Proposing Proxy Access – Limiting Broker Discretionary Voting

The Editor interviews Patrick Dooley, Partner, Akin Gump Strauss Hauer & Feld LLP.

Editor: Tell us about recent developments affecting how shareholders vote for directors of public companies.

Dooley: The first was the approval by the SEC of a proposal by the New York Stock Exchange to limit the ability of brokers to vote on a discretionary basis for directors if no instructions had been received from their customers. The old rule, which permitted discretionary voting in uncontested situations, reflected the fact that it is quite typical for retail investors to fail to give instructions on voting for a board of directors in a routine election. The new rule had its genesis in a proposal from the NYSE that goes back to 2006. The SEC action on that was delayed because the SEC was evaluating what changes in proxy access it was going to propose itself. But as the SEC finalized its own thinking, this rule was approved.

Under the new NYSE rule if a retail customer doesn't give instructions, brokers are precluded from discretionary voting for management directors. Eliminating discretionary voting by brokers is likely to significantly reduce the retail vote in favor of institutional investors, who vote at a much higher rate than retail shareholders.

The second is an SEC proposal for what is called proxy access, which provides a shareholder with the right, if certain conditions are satisfied, to include its nominee in the company's proxy statement and proxy card, as well as to place an explanation in the proxy statement not exceeding 500 words as to why its nomi-



Patrick Dooley

nee should be elected. The SEC proposal is at this point just that, a proposal. There is a public comment period that runs through August 17, following which the SEC is expected to issue final regulations.

Lastly, recent changes to the corporate law in Delaware – where many public companies are incorporated – permit Delaware corporations to include bylaws that would give corporations the flexibility to adopt a proxy access bylaw, which could be broader or narrower than the approach taken in the SEC proposal, and make it clear that companies can reimburse shareholders for the costs of proxy contests. Given the heightened interest in proxy access, Delaware's action was in part designed to permit proxy access if corporations (or shareholders, to the extent permitted) wished to adopt it, while trying

to preserve some flexibility in the application.

Editor: You mentioned a shift in voting power from the retail shareholder to institutional investors. Does that increase the influence of proxy advisory services?

Dooley: Many institutions, but not all, tend to vote as recommended by various proxy advisory services, including, most significantly, Risk Metrics Group, Inc. So, the concern is that to the extent the retail vote declines relative to the institutional vote, and institutions follow the advisory recommendations, these proxy advisory firms' influence will increase.

Editor: Could the SEC's proxy access proposal create more election contests?

Dooley: I think it could. First, it reduces the cost of running an insurgent nominee since no separate proxy card or statement is needed to get the nominee's name in front of the shareholders. Second, the inclusion of even one insurgent nominee sets the stage for a contest. Let's say you have a company that has five directors up for election this year. Normally the management slate would have five people listed for those slots. Under the SEC proposal, nominations for the closest whole number not exceeding 25 percent of the slots, or one director in my example, can be made. So, in a five-person board, one slot could be contested. The typical rule is that the top five vote getters would form the board of directors for the next year. If the shareholder's nominee receives more votes than at least one of the other man-

agement nominees, that person would then be elected to the board.

Editor: What standards must a nominating shareholder meet?

Dooley: The proposed SEC rule requires the nominating shareholder to have a certain minimum threshold stock ownership of between one and five percent of the company depending on its market cap, which they must have held for at least a year, and have no intent to change control of the issuer. There are a lot of issues to be worked out, such as what to do when more than one shareholder seeks to place nominees on the board. The current proposal is that the first shareholder to file a request gets to place its nominee on the ballot. These complexities have to be sorted out to minimize the risk of confusion and the potential opportunity for mischief, as different people think of different ways to maximize their influence.

Editor: Would the regulation preempt inconsistent state law and corporate bylaws meeting the requirements of state law?

Dooley: The SEC appears to take the position that it has the authority to propose access regulations that effectively mandate or affect what traditionally have been matters of state corporate law, such as access to the company's proxy statement and proxy card. It has yet to be determined whether this exceeds the SEC's authority, and it is possible there could be litigation in the future.

Assuming that the SEC has the necessary authority, there remains the question of what happens if a Delaware bylaw adopted in accordance with the new Delaware statute contains provisions on access that are more restrictive than the SEC's rules. Which one of those rules should govern? Is it appropriate for the SEC to provide for a different level of access and upon different terms and conditions than the company itself under a valid state statute? The SEC release essentially contemplates that proxy access under its rule could not be subjected to more restrictive provisions under state procedures.

Editor: Are there important consequences of proxy access and elimination of discretionary voting that need to be considered?

Dooley: As to proxy access, it is clear that

the process contemplated by the SEC proposal and facilitated by the Delaware changes could make it easier and less expensive for shareholders to propose nominees and to successfully elect nominees to the board of directors. Nevertheless, it will still be necessary, if the proponents of a shareholder nominee are serious about the election of their nominee, for them to supplement what they include in management's proxy statement. They will need to communicate with the shareholders in order to build the case for their nominee.

As to the discretionary voting change, one concern is that with the elimination of the broker vote, it may not be possible to obtain a quorum in order to conduct business at a shareholders meeting, since if the only item on the agenda is the election of directors, the brokers can't vote on a discretionary basis. A solution will be to have at least one other item on the agenda in addition to the election of directors since the discretionary voting rules do not restrict broker votes on other routine items, such as ratification of auditors.

A more difficult challenge relates to the impact of the discretionary voting change on voting requirements for directors. The traditional rule for electing directors is the plurality process whereby whoever gets the most votes is elected, even if a director gets only one vote. This sparked criticism among shareholder activists. In excess of 70 percent of the S&P 500 have now adopted what are called majority voting requirements, which provide that a director running for election is either not reelected or is required to offer his or her resignation if he or she doesn't receive a majority of the votes cast. This scenario becomes more likely if the broker discretionary votes are no longer counted and there is a vocal minority of institutional investors, either voting on their own or at the recommendation of the proxy advisory services in a vote "no" campaign because they are unhappy with the company or a director.

Also, in recent years there has been a desire to move towards the use of e-proxies in an attempt to be environmentally aware and reduce costs.

Recent experience with e-proxies has shown that the response from retail investors is much lower. This compounds the problem resulting from ending broker discretionary voting for directors. For this reason, companies concerned about poor turnouts may elect not to use the e-proxy approach.

Editor: What is the bottom line?

Dooley: It is likely that proxy access will be implemented in something similar to the form that has been proposed. Barring a successful legal challenge to the SEC's authority, the proxy access rules in some form will be here to stay. This, together with the diminished participation of the retail shareholder vote, is likely to be present for the foreseeable future. Businesses and shareholders will need to adapt to the new regime. The impact on majority voting may be particularly noticeable because we may see an increase in situations where directors do not receive majority votes.

Editor: What can companies do to increase the retail vote?

Dooley: It boils down to seeing that the retail investor has the incentive to vote. Historically, voting made little sense except in connection with a significant corporate transaction such as a merger. Education campaigns need to be undertaken to make sure that the shareholders really do understand that it is important to vote. Also, consideration needs to be given to expanded descriptions of why each nominee on the management slate of directors is of value to the company.

Editor: The investor has always had the right to sell stock in a company if it disagrees with the company's policies. Why is proxy access needed?

Dooley: The other side of the argument is that if I am a shareholder of a company and am unhappy, rather than selling, I have the right to be involved in the election of directors. The SEC proposal enhances my ability to make a recommendation about people who I think would make good directors.

The SEC proposal does include a requirement that shareholders making nominations not have an intent to seek to influence control of the company. If that rule is respected, the optimistic view is that shareholders who nominate individuals will do so because there are aspects of the company's policies that they object to and that if their nominee is successfully elected, it will foster the presentation of a greater diversity of views to the company's board. The less optimistic view is that shareholders with narrow concerns will use the process principally to advance that view. The end result remains to be seen.