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DETERMINING AND DISCLOSING THE EFFECT OF BROKER NON-VOTES

Brokers may vote uninstructed shares only on matters that are discretionary under NYSE Rule 452. The authors discuss the NYSE rule and the effect of broker non-votes under various voting and quorum standards under Delaware law. They suggest practitioners be particularly attentive to the disclosure of the effect of broker non-votes in proxy statements. They also caution that since the regulations are seldom perfectly clear, issuers and practitioners will often benefit by seeking NYSE guidance on whether brokers have discretion to vote uninstructed shares on specific proposals.

By John Mark Zeberkiewicz and Robert B. Greco *

In the past year, stockholder-plaintiffs' firms have seized on the confusion surrounding the treatment of so-called "broker non-votes" and have asserted claims challenging the effectiveness of various corporate actions — principally increases in authorized capital stock and reverse stock splits — on the basis that the disclosure in the proxy statement as to the effect of broker non-votes was materially misleading. Several corporations have received stockholder demand letters as a result of such alleged disclosure deficiencies and at least one was the target of a lawsuit seeking to invalidate a reverse stock-split.¹ Due to the plaintiffs' scrutiny of proxy statements, issuers and their counsel should take additional measures to ensure that they have accurately

determined and disclosed how broker non-votes, if any, will be treated.

Rule 452 of the New York Stock Exchange governs the ability of brokers to vote shares they hold on behalf of beneficial owners that fail to submit voting instructions for matters brought before a stockholders' meeting. As Rule 452 applies to all brokers that are members of the NYSE, it applies to both shares listed on the NYSE, as well as those listed on other securities exchanges.² In circumstances where brokers are prohibited from voting uninstructed shares on at least one proposal to be brought before a meeting of stockholders, but retain discretionary authority over one or more other proposals, the brokers may vote the uninstructed shares by proxy on the discretionary

¹ See, e.g., Amended and Supplemented Complaint, *Patel v. Galena Biopharma, Inc.*, C.A. No. 2017-0325-JTL (Del. Ch. June 2, 2017).

² SEC Rel. No. 34-60215, at 20 n.69 (2009).

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matters so long as they physically cross out the portions of the proxy card relating to matters for which they lack discretion.³ In this case, no vote is cast on any non-discretionary matter, causing a “broker non-vote” to occur for uninstructed shares with respect to such matter.

Under the Securities and Exchange Act of 1934, proxy statements soliciting proxies for stockholder meetings must disclose the effect of broker non-votes on the matters to be brought before such a meeting.⁴ Summarizing the effect of broker non-votes has become a source of confusion among issuers and their counsel, due in large part to the fact that NYSE Rule 452 does not set forth a clear standard for delineating between discretionary and non-discretionary matters. Moreover, the actual effect of broker non-votes depends not only on an interpretation of the text of the rule itself, but also on the impact that brokers having (or lacking) discretionary authority has on state law voting and quorum requirements, which may vary among issuers based on the thresholds set forth in their organizational documents.

NYSE RULE 452

NYSE Rule 452 governs whether brokers may exercise discretionary authority to vote shares as to which the beneficial owner has not provided voting instructions. It provides that when a broker has not received voting instructions from the beneficial owner of stock, the broker may generally:

give or authorize the giving of a proxy to vote such stock, provided the person in the member organization giving or authorizing the giving of the proxy has no knowledge of any contest as to the action to be taken at the meeting and provided such action is adequately disclosed to stockholders, and does not include authorization for a merger, consolidation, or any other matter which may affect substantially the rights or privileges of such stock.

NYSE Rule 452 does not itself provide clear guidance as to what matters are discretionary and non-discretionary. While the NYSE’s supplementary materials relating to Rule 452 enumerate a list of matters as to which brokers lack discretionary authority to vote, the list is prefaced with the qualifier “generally speaking.”⁵ Included among the matters as to which brokers, “generally speaking,” lack discretionary voting authority are those that:

- are “the subject of a counter-solicitation” or “part of a proposal made by a stockholder which is being opposed by management”;
- “relate to a merger or consolidation (except when the company’s proposal is to merge with its own wholly owned subsidiary, provided its shareholders dissenting thereto do not have rights of appraisal)”;
- involve appraisal rights;
- “authorize[] or create[] indebtedness or increase[] the authorized amount of indebtedness”;
- “authorize[] or create[] a preferred stock or increase[] the amount of an existing preferred stock”;
- “alter[] the terms or conditions of existing stock or indebtedness”;
- involve the “waiver or modification of preemptive rights, (except when the company’s proposal is to waive such rights with respect to shares being offered pursuant to stock option or purchase plans involving the additional issuance of not more than 5% of the company’s outstanding common shares)”;
- change “existing quorum requirements with respect to stockholder meetings”;
- alter “voting provisions or the proportionate voting power of a stock, or the number of its votes per share (except where cumulative voting provisions

³ NYSE Rule 452.13.

⁴ Schedule 14A, Item 21(b).

⁵ *Id.* Rule 452.11.

govern the number of votes per share for election of directors and the company's proposal involves a change in the number of its directors by not more than 10% or not more than one");

- authorize "the implementation of any equity compensation plan, or any material revision to the terms of any existing equity compensation plan";
- authorize "the acquisition of property, assets, or a company, where the consideration to be given has a fair value approximating 20% or more of the market value of the previously outstanding shares";
- authorize "the sale or other disposition of assets or earning power approximating 20% or more of those existing prior to the transaction";
- authorize "a transaction not in the ordinary course of business in which an officer, director, or substantial security holder has a direct or indirect interest";
- are the election of directors, other than for companies registered under the Investment Company Act of 1940; and
- relate to executive compensation.⁶

Because the NYSE's supplementary materials qualify, even these specifically enumerated examples with the phrase "generally speaking," practitioners should contact the NYSE to seek specific guidance as to the application of Rule 452 with respect to any proposal. If an issuer or person soliciting proxies is in doubt as to whether brokers may vote uninstructed shares on a particular matter and requests guidance from the NYSE, the NYSE Listed Company Manual provides that the NYSE "will give the matter early consideration in order that indication as to the status of the proposal under [NYSE] rules may be included in the material sent to brokers."⁷ Indeed, if the proposal does not clearly fall within one of the categories addressed by the NYSE's supplemental materials, the Listed Company Manual even "encourage[s] that a draft copy of the proxy material be submitted for review."⁸

⁶ *Id.* As the foregoing list is non-exclusive, reference should be made to the NYSE's supplementary materials prior to making any determinations as to whether a matter is discretionary.

⁷ NYSE Listed Company Manual, § 402.06(E).

⁸ *Id.*

EFFECT OF DISCRETIONARY AUTHORITY ON VOTING AND QUORUM REQUIREMENTS UNDER DELAWARE LAW

Once a determination is made as to whether brokers have discretion to vote uninstructed shares, the effect of such discretion (or lack thereof) on the voting and quorum requirements applicable to the proposals to be brought before the meeting must be ascertained. For Delaware corporations, which may establish their own voting or quorum requirements through bylaw or charter provisions,⁹ subject to specified statutory minimum thresholds,¹⁰ the effect of broker non-votes may vary between corporations.

Often, the determination as to whether the vote on a proposal submitted to stockholders at a meeting has satisfied the applicable voting requirement is made by reference to the number of shares present in person or by proxy at the meeting and entitled to vote on the proposal. For example, under Delaware law, the default voting standard for general matters (*i.e.*, matters other than the election of directors and matters as to which a minimum vote is prescribed by statute, such as the adoption of a charter amendment or merger agreement) is the affirmative vote of the holders of a majority in voting power of the outstanding shares present in person or represented by proxy at the meeting and entitled to vote thereon.¹¹

Determining the denominator in this calculation turns on whether shares for which broker non-votes occur are deemed present and entitled to vote on non-discretionary matters, a question addressed by the Delaware Supreme Court in 1988 in *Berlin v. Emerald Partners*.¹² *Berlin* involved a dispute as to whether a provision in a corporation's certificate of incorporation requiring certain business combinations to be approved at a meeting of stockholders by "[t]he affirmative vote of 66⅔% of the voting power present, in person or by

⁹ 8 *Del. C.* § 216; *see also Licht v. Storage Tech. Corp.*, 2005 WL 5757607, at *3-4 (Del. Ch. May 6, 2005).

¹⁰ Delaware's General Corporation Law specifies the minimum vote applicable to stockholder votes on, *inter alia*, sales of all or substantially all of a corporation's assets, dissolutions, conversions and most charter amendments, mergers, and consolidations, 8 *Del. C.* §§ 271(a), 275, 266(b), 242(b)(1), 251(c), and provides that a quorum must not be less than one-third of the voting power entitled to vote at any meeting. *Id.* § 216.

¹¹ *Id.*

¹² 552 A.2d 482 (Del. 1988).

proxy, at such meeting, excluding all voting securities owned beneficially, by the Acquiring Entity” was met in connection with the vote on a merger.¹³ Brokers lacked discretion to vote uninstructed shares on the merger proposal, but a different discretionary item was also on the agenda for the meeting. As a result, brokers submitted proxies to vote the uninstructed shares on the discretionary matter but withheld the authority to vote such shares on the merger proposal, causing broker non-votes to occur in connection with the vote on the merger proposal.

Although the shares for which broker non-votes occurred were deemed present and entitled to vote on the discretionary proposal, the Supreme Court held that these shares should be excluded from the “universe” of voting power present for the purposes of the vote on the merger proposal. In so holding, the Court explained:

[W]here a proposal is non-discretionary and the broker or fiduciary record holder receives no instructions from the beneficial owner, voting power on that proposal has been withheld. The shares represented by a limited proxy cannot be considered as part of the voting power present on a non-discretionary proposal from which power has been withheld by crossing it out or otherwise.¹⁴

Accordingly, Delaware law provides that if broker non-votes occur in connection with the vote on a matter, the shares for which the broker non-votes occur are not deemed present and entitled to vote on such matter.

For votes in which the applicable voting threshold is based on the proportion of shares or voting power present in person or represented by proxy and entitled to vote on the matter that vote in favor of the proposal, this means that broker non-votes will not result in votes in favor of the proposal or count towards the number of shares or voting power present and entitled to vote on the matter. Thus, under this standard, broker non-votes have no effect on the vote’s outcome.¹⁵

Broker non-votes, which inherently cannot be cast, also have no effect on proposals subject to voting thresholds based on a proportion of the votes cast.¹⁶

For certain matters, such as votes on a merger¹⁷ or charter amendment,¹⁸ the applicable voting threshold may be a proportion of the voting power possessed by all of a corporation’s outstanding shares entitled to vote on the matter. Under this standard, broker non-votes reduce the number of shares that may be voted in favor of the proposal — that is, they do not factor into the numerator — but have no effect on the denominator, which is fixed as the total number of votes attributed to all of the corporation’s outstanding stock.¹⁹ Broker non-votes therefore have the effect of a vote against proposals

¹⁶ In addition to disclosing the effect of broker non-votes, proxy statements must disclose the effect of abstentions on any vote to be brought before the meeting. Schedule 14A, Item 21(b). Particular caution should be heeded in making such disclosure in connection with votes requiring a proportion of the votes cast under applicable stock exchange rules. For proposals that must be approved by a majority of the votes cast under NYSE regulations, the NYSE has indicated that such proposals will only pass if the number of votes cast in favor of the proposal exceeds the sum of the votes cast against the proposal plus any abstentions. Memorandum from NYSE Regulation to NYSE Listed Company Executives (January 10, 2018), *available at* https://www.nyse.com/publicdocs/nyse/regulation/nyse/NYSE_2018_Annual_Guidance_Letter.pdf. But, under Delaware law, this standard has generally been interpreted as requiring that more votes be cast in favor of a proposal than against it. John Mark Zeberkiewicz & Megan W. Shaner, *An Overview of Delaware-Specific Issues for Stockholders’ Meetings*, 43 Rev. Sec. Comm. Reg. 275, 280 (2010); *see also Hammersmith v. Elmhurst Chicago Stone Co.*, 1989 WL 99129, at *3 (Del. Ch. Aug. 17, 1989) (interpreting an abstention as a “voluntary decision not to vote”); Mark A. Morton & William J. Haubert, *Abstentions and Broker Non-Votes in Delaware*, 7 Insights 36, 37 n.29 (1993) (“The authors do not . . . read the *Berlin* decision as implicitly holding that abstentions should be counted as ‘votes cast.’”); *but see Licht*, 2005 WL 5757607, at *5 n.28 (noting that “[t]here may be some debate as to whether an abstention is a vote”).

¹⁷ *See, e.g.*, 8 Del. C. § 251(c).

¹⁸ *Id.* § 242(b)(1).

¹⁹ *Knowles v. Advanced Photonix, Inc.*, 2014 WL 413938 (Del. Ch. Feb. 2, 2014) (Order) (holding that where a proposal needed to be approved by the “affirmative vote of stockholders representing a majority of the whole capital stock entitled to vote,” shares for which broker non-votes occurred counted towards the calculation’s denominator but did not result in votes cast in favor of the proposal).

¹³ *Id.* at 487.

¹⁴ *Id.* at 494–95.

¹⁵ *Cf. In re Cheniere Energy, Inc.*, 2015 WL 1206722, at *5 (Del. Ch. Mar. 16, 2015) (Order) (“Any such vote will be subject to a ‘majority of the shares present and entitled to vote’ standard. For the avoidance of doubt, pursuant to this standard, . . . broker non-votes will not be considered in determining the outcome of the resolution.”).

requiring the affirmative vote of the holders of a proportion of a corporation's total outstanding voting power or shares.²⁰

While less common, some voting standards require the affirmative vote of a proportion of the shares or voting power present at the meeting and entitled to vote thereat — *i.e.*, the shares or voting power present at the meeting and entitled to vote on *any* matter before the meeting. Under this standard, if at least one discretionary item is on the agenda, shares for which broker non-votes occur will be considered present and entitled to vote at the meeting, thereby increasing the denominator, but will not be cast in favor of the non-discretionary proposals for which the broker non-votes occur. As a result, broker non-votes will have the effect of votes against such non-discretionary proposals. If all of the items are non-discretionary, there is no need for a broker to submit a proxy and broker non-votes will generally not occur.²¹ In this case, uninstructed shares will not be present at the meeting and will have no effect on the outcome of votes subject to this type of voting standard.²²

²⁰ See *In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006) (observing that where no vote is cast on a proposal that must obtain the vote of a "majority of the outstanding stock of the corporation entitled to vote," the effect is "a *de facto* no vote").

²¹ As submitting a proxy with all of the proposals listed thereon crossed out would be a futile endeavor, brokers will generally refrain from submitting proxies to vote uninstructed shares in connection with meetings for which there are no discretionary matters. In this circumstance, broker non-votes will not occur for the uninstructed shares. Rather, the uninstructed shares will simply not be present at the meeting.

²² Theoretically, a broker non-vote could occur if a beneficial owner provided a broker with instructions to vote on one or more non-discretionary matters but failed to provide instructions on other non-discretionary matters. In this case, the broker would need to submit a proxy to vote the beneficial owner's shares on the matters for which instruction was given and cross out any remaining non-discretionary matters, a broker non-vote to occur with respect to the uninstructed matters. As the shares subject to the proxy would be entitled to vote at the meeting on the proposals for which instructions were given, the broker non-votes occurring for the other proposals would increase the denominator of the voting threshold applicable to such other proposals but not result in additional votes cast in their favor, thereby having the effect of a vote against the proposals for which the broker non-votes occurred.

Broker non-votes generally have a similar effect on quorum requirements, which are typically based on the proportion of the voting power present and entitled to vote at a meeting.²³ If brokers have discretionary authority on at least one item on a meeting's agenda, assuming this discretion is utilized, uninstructed shares for which broker non-votes occur will constitute voting power present for the discretionary matter and will therefore count towards a quorum under this standard. But, if no discretionary items are on the agenda, broker non-votes will generally not occur and uninstructed shares will not be deemed voting power present for any matter before the meeting, resulting in such shares being excluded from the calculation of a quorum.

CONCLUSION

Determining the effect of broker non-votes is not a straightforward endeavor; it involves the intersection of stock exchange regulations with state law voting and quorum requirements, including as those requirements have been modified, where permitted, by the issuer's organizational documents. Given the recent scrutiny that the disclosure of the effect of broker non-votes has drawn from plaintiffs' firms, practitioners should be particularly attentive in preparing such disclosure. Because the applicable regulations are seldom perfectly clear, issuers and practitioners will often benefit from seeking specific guidance from the NYSE as to whether a particular proposal is one as to which brokers have the discretion to vote uninstructed shares.

Issuers and their counsel are also urged to consider the effect of broker non-votes in light of applicable state law quorum and voting requirements. Under Delaware law, broker non-votes have the following effect under each of the below voting standards:

- *a majority in voting power of the shares present in person or represented by proxy and entitled to vote thereon* – No effect;
- *a majority of the votes cast* – No effect;
- *a majority (or greater proportion) of the outstanding voting power entitled to vote thereon* – Vote against;

²³ 8 Del. C. § 216(1) (setting forth a default quorum under Delaware law of the presence in person or by proxy of the holders of a majority in voting power of the shares entitled to vote at the meeting).

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- *a majority in voting power of the shares present in person or represented by proxy and entitled to vote*
 - *thereat; at least one discretionary item on agenda – Vote against; and*
 - *a majority in voting power of the shares present in person or represented by proxy and entitled to vote thereat; no discretionary item on agenda –*

Uninstructed shares will have no effect but broker non-votes will generally not occur.

Broker non-votes will count for quorum purposes under Delaware law so long as at least one discretionary item is on the meeting's agenda; otherwise broker non-votes will generally not occur and uninstructed shares will not be counted towards a quorum. ■