

## Special Report



### CORPORATE GOVERNANCE

## CIRCULARITY OF OWNERSHIP

by DAVID K. BISSINGER

Forget Enron Corp. and WorldCom Corp. The past year has witnessed an explosion of new scandals and debate over corporate governance issues: options backdating, executives spying on directors, U.S. Securities and Exchange Commission rulemaking over shareholder access to director ballots, and the indictment of class-action behemoth Milberg Weiss Bershad & Schulman. What connects these seemingly disparate issues? It's the power structure of publicly traded corporations.

Investors own corporations, but only through institutional money managers such as mutual funds and the like. These managers control the proxy process, which is the ballot box of corporate America. Proxy votes determine the identity of directors as well as whether corporations should offer new or additional securities, undertake mergers and acquisitions, or execute other major transactions.

The money managers who control the proxy process often serve as sub-

sidaries or affiliates of financial conglomerates whose investment bankers play key roles in matters subject to the proxy process. The money managers underwrite securities offerings, advise corporations in mergers and acquisitions and so on. In fact, as former Vanguard Chairman John Bogle put it in an Oct. 3, 2005, op-ed in *The Wall Street Journal*, "[M]ost of our largest money managers are themselves now owned by giant financial conglomerates. Arguably, this circularity of ownership allows corporate America to control itself."

This circularity of ownership lies behind each of this year's major issues in corporate governance.

1. The various options backdating scandals arose, at least in part, from directors' failure to catch executives granting themselves stock options with strike dates that tend to inflate their value.

2. Allegations in the Hewlett-Packard spying scandal reveal that some executives felt entitled to police the board of directors. Traditional corporation law teaches the opposite: Directors should have the upper hand.

3. The Milberg Weiss indictment raises questions about class-action lawyers serving as instruments of corporate governance reform.

4. The SEC has undertaken rulemak-

ing regarding whether, and to what extent, individual shareholders may nominate directors on corporate proxies. Currently, shareholders must launch their own proxy campaigns to nominate directors. These expensive campaigns have poor prospects of success. Corporate governance experts such as former SEC Chairman Arthur Levitt have pushed for this change. However, would such a change matter, given the control money managers have over the votes?

Each of these issues reflects forces that have sought to fill the vacuum of power in the absence of traditional shareholder control. These scandals and policy debates will continue until, in Bogle's words, the nation finds a way to "honor[] the interests of our citizen-investors and put[] these beneficiaries in the driver's seat where they belong."

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