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CORPORATE GOVERNANCE IN RUSSIA: EFFECTS OF OWNERSHIP CONCENTRATION ON CORPORATE GOVERNANCE IN THE RUSSIAN FIRMS

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This Master Thesis examines corporate governance in Russia and effects of ownership concentration on dividend policies in the Russian companies. We find that the classical agency approach is not applicable in the case of the Russian firms, but the stakeholder theory should be applied instead. We discuss effects of different stakeholders on the corporate governance. According to the existing evidence insiders (large shareholders, managers and employees) and outsiders (minority shareholders and creditors) can impose constraints on the companies in Russia. Also the State and product markets can affect corporate governance practices in the Russian companies. At the same time the role of boards of directors is very important in countries like Russia, where low legal enforcement and weak investor protection prevail. Boards should mitigate the agency problem in absence of proper investor protection and law enforcement.

The previous research suggests that a classical conflict of owners and managers is not the case in the Russian corporations. Instead the conflict of large and small shareholders should be considered. Thus, our research focuses on the analysis of ownership concentration effects on corporate governance. We use dividend payout ratios as a proxy for corporate governance practices in the Russian companies. We find extremely low dividend payouts in the Russian companies. The finding implies that the agency problem does exist in the Russian companies. However, our results suggest that it is not caused by ownership concentration. Instead ownership concentration has a significant positive effect on dividend payouts. Our findings support the prior research suggesting that a large shareholder has enough incentive and power to monitor management. The results are also in line with the substitute dividend model, according to which we can conclude that large shareholders would compensate minority shareholders for weak investor protection and also would try to establish good reputation on the capital markets.

Keywords
agency problem, large shareholders, dividend policies

Additional information
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1 INTRODUCTION

“The directors of companies being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own.... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.”

Adam Smith (1776)

In the past 10 years Russia has become a huge consumer market and a country with a big investment potential. Russia accommodated production plants and foreign offices of large multinational corporations. The Russian stock market grew rapidly during the last decade, drawing more and more of foreign capital. Russian oil and gas has become highly valued among the investors as the world population and consumption continue to grow rapidly. During 2005-2010 the Russian stock exchange RTS delivered steady double-digit returns to investors, and the country's performance is expected to continue showing sign of improvement.

However, Russia has never been the easiest country to invest and to do business in. Usually emerging markets provide new investment opportunities, but there are significant risks as well - both for domestic and foreign investors. The Russian corporations, as an investment, are considered to contain a huge risk of the agency problem. Massive corruption scandals have occurred recently both in public and private sectors. And even worse, often no legal actions have followed them. Especially high concentration of ownership and expropriation of minority shareholders by controlling shareholders have become typical features of the Russian corporate governance. Also low legal protection of shareholder rights and excessive interference of the state with business contribute dramatically to the risk of agency problem. Insufficient corporate governance structures result in extremely low valuations of the Russian firms.

The aim of this research is to define determinants of the Russian corporate governance and analyze ownership effects on corporate governance practices in the Russian corporations. We proceed with the research as follows.
Chapter 2 focuses on corporate governance and agency problem in Russia in general. We find that agency relationship in its classical interpretation is not applicable in the Russian case, but the stakeholder agency theory (SAT) should be applied instead. Based on SAT we develop a framework to analyze determinants of corporate governance in Russia. The stakeholder agency theory is used for description of the Russian corporate governance and further analysis in Chapter 2 will be done from this perspective. We find that the following stakeholders affect corporate governance in Russia.

- Large shareholders
- Creditors
- the State
- Boards of directors
- Product markets
- Employees

Ownership concentration is a distinguishing feature of the Russian firms. Lazareva et al. (2007) find that the classical agency conflict of managers and shareholders is not an issue in Russia, but a conflict of large and minority shareholders should be considered instead. Value of control is extremely high in Russia, where low investor protection and insufficient legal enforcement prevail. In civil law countries, which Russia is, corporate control is valuable because it makes expropriation of minority shareholders more efficient (La Porta et al. 1999). Legal approach suggested by La Porta et al. (1999, 2000) is worth considering. Further in Chapter 4 we test ownership concentration effects on corporate governance using dividend payouts as proxy for corporate governance.

Russia has a weak capital market (Lazareva et al. 2007). This makes companies to rely on internal financing to a very large extent. And even if a company succeeds to raise external funding, managing debt is not straightforward in countries like Russia. Creditors in order reduce risks of default can set stringent constrains on company management in the civil law countries, for instance, on company’s dividend policies. This may be seen as a substitute for weak investor protection (Brockman & Unlu 2009). Limited dividends and high capital costs can be viewed as agency costs imposed on the shareholders of the company. Brockman and Unlu refer to these costs
as agency costs of debt. Creditors and minority shareholders can be viewed as outsiders who have a stake in a company.

Next we discuss the role of the state in the Russian economy. The role of state has increased during Putin’s period (Sprenger 2010). More than 47% of stock market capitalization was delivered by the state-owned companies in Russia in 2006, 17% more than in 2004. State-owned firms are the subject to higher agency costs, because they might pursue goals other than maximization of long-term company value.

The role of boards of directors is especially high in countries with low investor protection, as they perform monitoring and controlling of management of a company and intended to protect minority shareholders. MacCarthy and Puffer (2002) suggest that the Russian boards are mainly insider boards. However, the situation is changing and increasing number of independent directors occupy seats on the Russian boards. Lazareva and Summanen (2007) find that board of directors play mainly an advisory role in the Russian firms. They also spend more time on strategic and tactical issues than on monitoring and controlling of management.

Further we describe the role of product markets and employees. Undeveloped product markets in Russia can lead to significant extra cash flows at management’s disposal and, thus imply risk of the agency problem; whereas competition on developed product markets should reduce the amount of extra cash under management’s discretion and reduce agency costs. Employees can impose constraints on the management due their relatively high ownership in the Russian companies. Both product markets and employees, however, are able impose only weak constraints on management.

Chapter 3 is dedicated to the main conflict in the Russian corporations which is the one between large and minority shareholders. First we analyze the international evidence. It is sensible to use legal origin approach for better understanding of the problem. La Porta et al. (1999) divide countries into civil and common law countries. The common law countries cultivate better corporate governance standards and strong investor protection. For these countries dispersed ownership and expropriation of shareholders by management are typical. On the contrary, (the) civil law countries provide weak investor protection while ownership is highly concentrated in these
countries. Minority shareholders are expropriated by large shareholders, which is the case also in Russia. As an outcome of better governance practices companies in common law countries pay higher dividends than in civil law countries. This is referred as the outcome dividend model. However, shareholders in the common law countries are willing to accept lower dividends, if a company is expected to grow. Shareholders in civil law countries would always try to extract maximum dividends regardless growth opportunities. The alternative substitute dividend model implying that dividend payouts are higher in the civil law countries as a compensation for weak investor protection does not hold. (La Porta et al. 2000.) We analyze a huge body of international evidence and come to a general conclusion, that large shareholders affect corporate governance and company performance positively acting as a substitute to investor protection, if their incentives are aligned with those of small shareholders. Large shareholders have enough power and incentive to monitor management and in case of underperformance to implement management turnover. In civil law countries large shareholders might adopt high dividend policies in order to compensate minority shareholders for weak shareholder rights protection and to establish reputation on the capital markets. Nevertheless, ownership concentration effects are too complex to be interpreted conclusively. One should take into account identity of large shareholders. The recent research suggests broad owner classifications may lead inaccurate results. For instance, Pergola and Verrault (2009) suggest that a large shareholder’s incentives are best aligned if the shareholder is an independent corporate block holder in a company with diverse ownership or independent institutional investor from the private sector who exercises value strategies. On the other hand affiliated large shareholders may use control for extraction of private benefits, while large individual shareholders with some exception are inefficient in monitoring management.

Chapter 3 continues with the analysis of ownership concentration effects in the Russian firms. As we mentioned before the relationship between large and minority shareholders is relevant in the Russian firms. Ownership concentration increased from Yeltsin’s to Putin’s period. However, the research suggests that expropriation of minority shareholders declined significantly in the 2000’s being at its highest during Yeltsin’s period. This is mainly due to the improvements in corporate governance standards and political stability during Putin’s period. Guriev and
Rachinsky (2005) suggest that oligarch companies achieved higher productivity that non-oligarch companies after year 2002. Maury and Liljeblom (2009) report higher valuations for oligarch firms in Putin’s period comparing to Yeltsin’s time. However, Liljeblom and Maury (2008, 2010) conclude that ownership concentration had a negative impact on dividend policies in 1997-2003, if a large shareholder was not the state. The studies of Liljeblom and Maury emphasize importance of employing owner classification when researching ownership concentration effects. For instance, they suggest that foreign ownership affects positively dividend payouts. One of their conclusions is that minority shareholder expropriation is present in the Russian companies.

In our empirical section (Chapter 4) we focus on ownership concentration effects in the Russian corporations. Our main hypothesis is that ownership concentration has a negative impact on corporate governance in the Russian companies, suggesting that incentives of large shareholders are not aligned with those of minority shareholder. We adopt La Porta’s et al. (2000) approach and use dividend payout ratios as a proxy for corporate governance. Higher dividends would mean better corporate governance practices. This should hold for the civil law countries, where low dividends imply that extra cash holdings stay in disposal of management that can spend them on projects destructing shareholder value. First we report extremely low dividend payout ratios in the Russian companies. The finding advocates the fact that shareholder expropriation is present. Nevertheless, the possible agency costs are not caused by large shareholders. Our hypothesis fails, as we report significant positive coefficients for ownership concentration regressed against dividend payouts. Our conclusion supports the work of Schleifer and Vishny (1997), as well as later research of Liljeblom and Maury (2009), Guriev and Rachinsky (2005). Large shareholders have enough power and incentive to perform efficient monitoring of management. Large shareholders can also act as a substitute for investor protection in countries like Russia, where weak investor protection and legal enforcement are present. High dividends in the companies with large shareholders can be seen as compensation paid to minority shareholders for weak investor protection, or as an attempt to establish reputation on the capital markets (substitute dividend model - La Porta et al. 2000). We recognize that our results might be inaccurate due to the fact that we do not distinguish between different owner types, and thus we suggest
employing detailed owner specifications in future research of effects of ownership concentration in the Russian corporations. Also we recognize that dividend payout ratios are not a perfect proxy for corporate governance practices. We suggest that direct measures of corporate governance, such as corporate governance indices, may perform better.
2 CORPORATE GOVERNANCE IN RUSSIA

Corporate Governance in its most classic interpretation means “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer & Vishny, 1997, 2) or according to Mallin (2002) “the exercise of power over and responsibility for corporate entities”

“Corporate governance systems recognize the inherent conflict among objectives of owner-shareholders and managers, and establish institutions, policies, and procedures to protect shareholders’ interests” (McCathy & Puffer 2002, 397). Corporate governance is an instrument employed to regulate agency relationship between owners of the company and management. Agency relationship is “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent” (Jensen & Meckling 1976, 5). If the principal and agent are both utility maximizers, there is a high probability that the agent will not act to maximize the principal’s utility, but his own, causing agency problem or agency costs as a result.

A term agency cost is closely related to agency relationship meaning the costs occurring as a result of such relationship. Jensen and Meckling (1976) define agency costs as a sum of:

1. monitoring expenditures by the principal\(^1\)
2. bonding expenditures by the agent\(^2\)
3. residual loss\(^3\)

Corporate governance as an instrument mitigating possible agency problem is very important. Particularly disclosure practices, agency costs and many other are the factors among of plenty that hugely contribute to the valuation of a company. Especially in countries like Russia where low legal enforcement, high concentration of ownership, weak social and financial institutions and, thus weakly protected

\(^1\) These also include any efforts of a principal to control the behavior of the agent through budget restrictions, compensation policies, operating rules, etc.

\(^2\) Costs of contracting in such a way that there is goal congruence between managers, directors, owners and community stakeholders

\(^3\) Costs as a result of divergence between an agent’s decisions and those that would maximize wealth of a principal
property and shareholder rights are typical, good governance practices are vital, as they have a huge impact on company valuations and ability to raise capital.

Corporate governance practices can indeed affect company’s stock prices hugely. Black et al. (2006) in their study of dependence of corporate governance indices and valuation of the Russian corporations between 1999 and 2005 conclude that there is a strong correlation between two and that market values of the Russian firms can be predicted on the basis of corporate governance indices. Low protection of shareholder rights causes high risk premiums for investors. For example Gazprom, the largest oil and gas company in the world by proven reserves, had market capitalization in October 2005 of only 1 dollar per barrel of proven reserves. The largest Western companies like Exxon Mobil and Royal Dutch Shell had market capitalization of 18 dollars per barrel of proven reserves at that time, which makes a tremendous difference with Gazprom’s figures and once again underpin the importance of corporate governance and investor protection in general. (Black et al. 2006.)

It is essential here to define the nature of corporate governance in Russia and relationships between managers, shareholders and other stakeholders (agency problem). Many researchers agree that classical agency theory implying a conflict between shareholders and managers as a conflict between a principal and agent is not applicable in Russia’s case. Lazareva et al. (2007) suggest that more appropriate would be to consider a conflict between controlling shareholders and minority shareholders. Buck et al. (1998) as well find that the classical agency theory (AT) is not comprehensive and does not describe explicitly all the relationships in the Russian corporative world. They suggest the stakeholder agency theory (SAT) as an alternative to the AT. The stakeholder agency approach differs from the AT in the following way (Table 1):
Table 1. Distinctive features of AT and SAT (Buck et al. 1998).

<table>
<thead>
<tr>
<th>Classical AT</th>
<th>SAT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial approach – implying a purely financial relationship between the principal and the agent. Financiers provide managers with capital and impose constraints on them in order to secure return on this capital. All other relationships are basically ignored.</td>
<td>Stakeholder agency approach implies also other than financiers-managers relationship. For instance, employees of a firm can impose constraints on managers’ decisions. Often this relationship does not have a financial nature. Also the state can impose non-financial constraints on managers.</td>
</tr>
<tr>
<td>EXIT based governance – implying one major constrain imposed on management. Managers are threatened by the fact that shareholders can sell their shares (shareholders’ exit)</td>
<td>Shareholders’ voice – stakeholders through formal channel of board representation can influence decisions of management.</td>
</tr>
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For further analysis of corporate governance in Russia we suggest the following framework (Figure 1.)

Figure 1. Framework for analysis of corporate governance in Russia.

Figure 1 shows the interactions of different stakeholders of a Russian company. These stakeholders are divided into insiders, outsiders and other stakeholders. Outsiders are expected to impose constraints on insiders, mostly on the management of a company. Insiders, however, would tend to expropriate outsiders. There is interaction among insiders as well, and, for instance, employees of a company can
also put constraints on management. Product markets and the state are also considered to have significant influence on managerial behavior. Further we will describe these interactions of stakeholders in more detail. As one can notice, the framework is derived mainly from the SAT, which implies that corporate governance regulates more complicated relationship of many stakeholders rather than a classical principal – agent relationship of the AT.

2.1. Large vs. minority shareholder – conflict

For Russia a classical agency conflict of managers and owners is not the case. Instead a conflict of large shareholders and minority shareholders takes place (Lazareva et. al. 2007). The privatization process taken place in the early 1990s in Russia created a significant group of shareholder-insiders, when the ownership of the companies that once were the foundation of the Soviet economy was dispersed between the managers and non-management employees of the companies (Lazareva et al. 2007). As a result, despite the initial intentions of the government to distribute the ownership among the Russian citizens more or less evenly, the ownership eventually concentrated in the hands of insiders. Further privatization led to an even higher ownership concentration level, as managers continued to add to their stake and a new group of shareholders, block holders, appeared. They are often referred to as oligarchs. Russian oligarchs are believed to own a huge stake in the Russian business, as approximately 40% of the Russian industry belongs to the business groups, controlled by them (Guriev & Rachinsky 2005). We thoroughly discuss ownership concentration effects in Chapter 3 and 4.

2.2. Creditors vs. Shareholders - conflict

As an extension of La Porta’s et al. 2000 theory Brockman and Unlu (2009) suggest an agency approach to explain relationship creditors and companies’ insiders. This approach presents creditors as investors who provide managers with funding and require return on their investments. Brockman and Unlu (2009) use the same division of countries into common and civil law countries. Russia according to them is a civil law country, and thus, weak legal protection of creditor rights and high ownership concentration prevail there. Their major finding is that creditors in civil law countries
impose heavy constraints on companies’ dividend policies which serve as a substitute to poor creditor rights protection. Brockman and Unlu discuss agency costs of debt, which imply that constraints imposed by creditors on companies’ management and businesses should be viewed as agency costs paid by shareholders. These costs incur from possible risk-shifting arising when management or shareholders engage in projects containing more risk than it was initially agreed with creditors. Riskier projects can result in higher gains for shareholders, but they also may cause losses for creditors. To restrain opportunistic behavior of management and shareholders creditors would set up covenants dealing with additional financing, dividends or lease restrictions. Eventually such contracting would lead to increased costs of capital (debt in this context) borne by shareholders. The restrictions on dividend policies found by Brockman and Unlu lead to lower dividend payouts, meaning agency costs to shareholders. One of the major findings Brockman and Unlu is that constraints imposed on management by creditors are even heavier than those imposed by shareholders. For this reason both minority shareholders and creditors are viewed as outsider financiers in our framework. Their relation to insiders of companies tends to be purely financial. Minority shareholders and creditors together represent capital markets.

Russia as many other transition economies has a weak capital market. Though the Russian stock exchange grew significantly in the recent years it still remained undeveloped in the 2000s (Lazareva et al. 2007). While the stock market capitalization relative to GDP (44%) matches the ratios of the developed countries, the volume of traded shares relative to GDP is significantly lower (25%). Many companies have to deal with very expensive external funding, as the refinancing rate remains quite high. The refinancing rate of Central Bank of Russian Federation is 8,25% (The Central Bank of the Russian Federation 2014). Debt financing under this rate is normally unavailable. Bond and equity issues are not common and companies tend to rely on internal funding. The banking sector is dominated by the state-owned banks with Sberbank holding almost 32% assets in the banking sector (Lazareva et al. 2007).

Pöyry and Mauri (2009) report the level of total financial debt of 10,2 as percentage to assets in the Russian firms in 2000. Such a low level is consistent with Lazareva et al. (2007) and Brockman and Unlu (2009). Firms dealing with weak capital market
and low investor protection environment would have to rely on internal financing and try to avoid possible heavy constraints imposed by creditors. However, Pöyry and Mauri indicate that the market for external capital developed and became more efficient over the time, as in 2004 the level of total financial debt was 23.5%.

2.3. The role of the State in the Russian economy

Despite massive privatization in the 1990s in Russia, state ownership still plays an important role in the Russian economy. Especially, five industries: infrastructure, financial services, natural resources extraction, military-industrial complex and mass media, are dominated by the state-owned companies Sprenger (2010).

Sprenger (2010) performs a thorough research of the Russian state-owned enterprises (SOE) between 1996 and 2009, and defines them as “enterprises where the state has significant control through full majority or significant minority ownership”. State control is referred to as control by “any level of government and through pyramid structures, i.e. direct and indirect ownership of the federal government, regional and municipal governments” Sprenger (2010). It is considered that significant control is gained through at least 10% ownership.

According to Sprenger (2010) about 40% of market capitalization on the Russian stock exchanges (RTS, MICEX) was controlled by the federal and regional authorities. The share increased since 2004 by more than 16%. Sprenger (2010) finds that state-owned companies (only with majority share of the state) accounted for more than 47% of market capitalization of the ten largest companies listed on the Russian stock exchanges. Though the share of the state ownership continues to grow in the strategic industries (energy, infrastructure, financial sector, military production and media), privatization of small and medium-sized SOEs takes place. Many state and municipal enterprises are being transformed into opened JSCs in order to make them more transparent and probably privatize them in the future.

One of the most important implications of a large state ownership in a company is the fact that the interests of the government might not be perfectly aligned with those of the shareholders. Actually the government may pursue social objectives instead of
the objective of maximizing share value. Sprenger (2010) lists the following objectives that the government might pursue:

- Equity objectives and the provision of public goods, especially electrical and heat energy, gas and other services. In fact, prices on electrical and heat energy for the public sector are still regulated by the regional government.
- Industrial policy objectives, e.g. investing in infrastructure with positive external effects that the company is not compensated for
- The protection of cultural values, e.g. offering non-commercial TV and radio.

Lazareva et al. (2007) provide a telling example, how state at all levels can interfere with business. Russia’s largest car manufacturer Avtovaz, that produces Ladas, employs approximately 1/5 of population of Toliatti-city. Avtovaz was rapidly losing market share and desperately needed re-organisation, which would have caused massive layoffs. However, re-organization was not politically feasible and the company was bailed out by the government.

Sprenger (2010) states that SOEs face mainly the same corporate governance related problems as private corporations, where owners have to monitor the “actions of and the level of effort of managers”. However, in the Russian SOEs many of those constraints that would typically reduce the agency problem in a private firm, are not at work. The following factors cause a higher risk of the agency problem in SOEs (Sprenger 2010):

- Low bankruptcy risk
- Low product market competition
- Low takeover threat
- Weak managerial labor market
- Nontransparent and highly informal procedure of the appointment of state representatives for the boards of directors
- Access to government subsidies
- Transparency issues
However, there is some evidence that SOEs are not outliers in terms of corporate governance. Avdasheva et al. (2007) review prior empirical studies on competition and industrial organization in transition markets. They conclude that SOEs perform better or equal to private companies. For instance, SOEs changed the composition of the boards of directors and CEOs more often than the private companies. Also the frequency of the meetings of the boards of directors was slightly higher for SOEs than for private companies in the preceding three years. The share of insiders on the board of directors of SOEs is lower, 32% versus 50% in private companies. Also Liljeblom and Maury (2008) give credit to SOEs. They find that ownership concentration in the Russian companies affected negatively dividend payouts in 1997-2003, but not in the companies with the state as the largest shareholder.

2.4. Boards of Directors

Lazareva and Summanen (2008) conduct a survey of 243 Russian companies in May-July 2006. They suggest that board of directors play an important role especially in transition economies as they might be considered as a substitute to legal protection of shareholders and financial market regulations, which are weak in emerging markets. Boards of directors are relatively young in Russia. They were introduced by the Law on joint stock companies and adopted from the Anglo-Saxon corporate model, where a board of directors is an organ that monitors management (Lazareva & Summanen 2008). Lazareva et al. (2007) suggest that in Russian corporations, where ownership is very concentrated, the boards of directors are not truly independent, but represent the controlling party in the firm. In 2006 insiders accounted for 66% share of members on the boards of directors of the 75 largest public companies in Russia Lazareva et al. (2007), minority shareholder representatives and unaffiliated directors accounted for 13.9% and 19.9% respectively. So, the decisions made by the boards of directors are greatly influenced by insiders.

MacCarthy and Puffer (2002) as well find that the Russian boards are inside boards, consisting exclusively of management. However, according to the researchers the practice is changing in better direction and more independent directors are introduced onto the Russian boards. For instance, Lazareva et al. (2007) find that boards of the
companies cross-listed on the Western stock exchanges have on average higher share of unaffiliated directors and lower share of insiders, 33 % and 38 % respectively for 7 companies listed on the NYSE/NASDAQ, and 31 % and 62,5 % for 17 companies listed on the LSE.

Lazareva’s and Summanen (2008) provide descriptive analysis of the Russian boards:

- An average board size - 7,7 directors
- Average share of outside directors on the board - 55 percent (independence might have been interpreted wrong by some of the respondents)
- Average number of board meetings - 13.
- Share of firms that have state representatives on the board – 29 % (positive related to a board size)
- Average meeting duration - 2.4 hours (board working intensity grows with board size: largest boards work about 1.5 times more than smallest boards)

Lazareva and Summanen (2008) find that, the boards in the Russian firms spend on average about two thirds of working time on strategic issues. This figure implies that monitoring of the CEO and management is not as important task of boards in Russian firms as in US companies with dispersed ownership structure, where the boards of directors would spend on monitoring management as much as 3 times more. And thus, Lazareva and Summanen (2008) suggest that in Russian firms with high ownership concentration monitoring of the management is performed directly by the large owners while board acts to a large extent as a council to the firm owners and managers in forming the strategy. In a way, ownership concentration serves as a substitute to other governance mechanisms in monitoring of management, such as boards of directors. In such situation a controlling shareholder has a high incentive to perform monitoring of the management directly.

Firms with insider as a major owner would typically have less outsiders on the board. Another interesting finding of Lazareva and Summanen (2008) is that boards with higher share of independent directors spend higher share of their time on strategy.
The researchers speculate further that the role of independent directors in Russian firms is not limited to monitoring and control, but they bring in the outside expertise and competence.

Higher share of independent directors leads to more heated debates both on strategy and on budget. This by the researchers’ opinion indicates that independent directors are not just hired for the formal or reputation reasons but they are playing an active role in board activities. As for the ownership structure, presence of controlling owner increases the degree of conflicts over company’s budget. Lazareva and Summanen (2008) conclude that it may indicate conflicts that arise when the controlling shareholder tries to expropriate minority shareholders; or it can be the result of higher monitoring activity of the controlling owner.

One of the major conclusions of Lazareva and Summanen (2008) is that the involvement of boards in strategic planning has no significant impact on the firms’ performance. The researchers speculate that companies might currently be at an optimal level of the involvement of the boards in strategic decision making (in equilibrium).

On the basis of the prior findings Lazareva and Summanen (2008) conclude that strengthening boards in such environments like Russia is necessary for development of good corporate governance practices. Especially, performing a monitoring function would be an appropriate for the Russian boards as it may be a good substitute for weak legal protection of shareholder rights.

2.5. **Product Markets**

Shleifer and Vishny (1997) suggest that product market competition reduces excess returns of a company, which is followed by lower agency costs, as managers would be left with lower cash holdings to expropriate from. Then, if the hypothesis is true, in case of Russia with its relatively low market competition, especially in 1990s, it could be concluded that undeveloped product markets create conditions for expropriation of shareholders by managers.
Another layer of influence of product markets on management is implied by Buck et al. (1998), who suggest that undeveloped product markets were almost the most important constraint imposed on managers in the middle of the 1990s. Collapsed demand forced managers use high portion of funds on short-term liquidity and job preservation instead of purchase new equipment and developing new products. However, Buck et al. (1998) find that product markets impose only weak constraints on managers, if soft credits are available. Shleifer and Vishny (1997) also find that though market competition is one of the most efficient tools, it hardly can improve corporate government alone. This conclusion refers to corporate governance in general, not particular Russia’s case. So, product markets impose only weak constraints on managers.

Buck et al. (1998) also indicate that though integration of producers with their customers appeared in Russia, no Japan-like model developed in Russia, when customers have representatives on their suppliers’ boards.

2.6. Employees

According to the SAT employees can impose constraints on management. The view is supported also by McCarthy and Puffer (2003) and Lazareva et al. (2007). According to Buck et al. (1998) employees having as an objective maximization of wages, improving employment security and working conditions would use informal channels of influence on management. However, the influence is very limited, as employees are usually more dependent on employers than the latter on employees. Employees may heavily rely on health care, nurse services, recreational and vacation facilities provided by employers. This causes bonding of employees to the firm. Weak labor markets make dependence of employees of firms even stronger. This one being probably true for the 1990s, might not be the case in the 2000s.

Lazareva et al. (2007) indicate that employees still have significant ownership in the employer-companies, which is a distinctive feature for the Russian firms. Employees’ shares may be a target for outside raiders who would intend to implement a takeover in the company. Unsatisfied workers may sell their share to the raiders and, thus threaten management positions.
Nevertheless, both Lazareva et al. (2007) and Buck et al. (1998) agree that employees can impose only weak constraints on management. They agree that employee-shareholders tend to vote together with managers. Employees would also tend to take a side of incumbent managers during corporate conflicts and, for instance, resist any attempts of a takeover by outsiders. This according to Lazareva et al. (2007) can be explained by the fear of layoffs that usually would be conducted by new management in case of a takeover.

So, basically employees while being a stakeholder party with its own objectives, impose weak constraints on management.

2.7. Improvements in corporate governance in Russia.

Importance of corporate governance is outlined by Badshah (2007) who report excess returns for the portfolio buying high-rank governance firm and shorting low-rank ones. High-rank governance Russian firms delivered significant robust positive returns, while low-rank companies delivered negative returns.

Ahmed (2008) and Zasada (2005) underline the significance of corporate governance as investor protection mechanism. They emphasize transparency and quality of earnings reporting which one step of protecting minority shareholder rights. Better corporate governance practices will result in higher market valuations of the companies in transition economies.

In general the majority of the researchers agree that Russia has improved significantly in terms of corporate governance during the recent years. McCathy and Puffer (2002) view listing on a foreign stock exchange as a method to improve corporate governance in a company. Vimpelcom was the first Russian company that was listed on the NYSE. The P/E -ratio of the company increased up to 20 in 2002 (McCathy & Puffer 2002). P/E –ratio measure stock price relatively to company’s earnings. Typically Western stocks exhibit high valuations when P/E –ratios measure over 10. The Russian stocks have been chronically inexpensive. Companies in Russia MSCI index were traded at average P/E –ratio of 5,6 in February 2013, which is one of the lowest valuations among emerging markets (Pavliva 2013). High stock valuations are associated with lower risks and usually with better corporate
governance practices. Vimpelcom in order to be listed on NYSE had to meet stringent requirements regarding corporate governance, which then resulted in a drastic valuation increase.

Pöyry and Mauri (2009) report increased financial debt levels in 2004, which results from increased confidence of the capital market towards the Russian firms. This is due to improved corporate governance and improvements of the Russian capital market itself.

Maury and Liljeblom (2009) on the basis of their sample (121 firms, 384 firm-year observations in 1998-2003) find that the fraction of the cross-listed Russian companies increased from 25% to 41% in 1999. In 2000-2003 this number varies between 36% and 50%. Here Maury and Liljeblom agree with previous findings of McCathy and Puffer (2002) and imply that cross-listings can be used as a governance mechanism, in particular, it can reduce agency costs, as a company when cross-listed on a foreign exchange would probably meet stiffer governance regulations, disclosure and transparency requirements.

Lazareva et al. (2007) and McCathy and Puffer (2002) find that introducing of the Code of Corporate Conduct was a great achievement and a step in right direction in terms of strengthening good corporate governance practices. The code was issued in 2001 with objective to provide a framework for corporate governance in Russian corporations. It is based on guidelines of the OECD and other international standards like those drafted by the World Economic forum. The Code is not obligatory for the companies, but in order to encourage compliance with it, companies with more than 1000 shareholders are required to disclose any deviations from the Code in their annual reports McCathy and Puffer (2002).

The major principals of the Code are (ECGI 2013):

1. Corporate conduct practice should provide shareholders with a real opportunity to exercise their rights in relation to the company;
2. Corporate conduct practices should secure equal treatment of shareholders owning equal numbers of shares of the same type (category). Equal protection should be secured for all shareholders if their rights are infringed upon.
3. Corporate conduct practices should secure strategic management of company operations by the board of directors and efficient control by the board of directors over the activities of executive bodies of a company, as well as accountability of the members of the board of directors of a company to shareholders thereof.

4. Corporate conduct practices should enable executive bodies of a company to exercise efficient management of company operations in a reasonable manner, in good faith and solely in the interests of a company, and should secure accountability of executive bodies of the company to the board of directors of a company and shareholders thereof.

5. Corporate conduct practices should secure timely disclosure of full and accurate information about the company, including its financial position, performance, ownership and management structures in order to enable shareholders and investors of a company to take reasonable decisions.

6. Corporate conduct practices should take into account statutory rights of parties concerned, including company employees, and encourage active cooperation between the company and the parties for the purpose of increasing the net worth of the company, the value of its shares and other securities, and of creating jobs.

7. Corporate conduct practices should secure efficient control over business and financial operations of a company for the purpose of protecting rights and lawful interests of shareholders.

In addition, the code provides detailed recommendations on the following issues (Lazareva et al. 2007):

- A general meeting of shareholders: calling and preparation of a meeting, agenda, procedures for conducting a meeting, voting procedures;

- A board of directors: its responsibilities, formation, members, independent directors, organization of board of directors’ activities, remuneration of directors;

- Executive bodies of the company (management board, general director), authority and responsibilities, members, formation, organization of activities, remuneration, answerability;

- Major deals, reorganizations: definition, procedures;
• Disclosure of information about a company: goals, forms, provision of information to shareholders, auditing, an auditing committee;

• Dividends: setting the amount, distribution procedures;

• Settlement of corporate disputes.

These standards and principals are intended for all economic entities, but are most vital for joint stock companies. This is for the reason that in JSCs separation of management and ownership is the greatest, and therefore the risk of agency problem is the highest. These standards should provide equal and adequate shareholder protection. The more the level of protection will be achieved, the higher valuations of Russian stock will be and more investment capital will be available for Russian firms.
3 LARGE vs. MINORITY SHAREHOLDERS –RELATION AS A MAJOR CONFLICT IN THE RUSSIAN FIRMS

An agency conflict between a professional manager and shareholders is not that much of an issue in Russia in the post-privatization period. A huge deal is a conflict between large and small stakeholders. High concentration of ownership in the Russian corporations is a way to abuse the rights of minority shareholders. Weak law enforcement caused the situation when having control over a company is very crucial because of the need to defend company’s assets from expropriation by managers or raiders on the one hand. On the other hand, strong control gives a large shareholder a possibility of extracting private benefits, and thus leads to violating of rights of minority shareholders. This makes value of control extremely high. (Lazareva et al. 2007). Further, we analyze international and Russian evidence of ownership effects on corporate governance.

3.1. International evidence of ownership concentration effects

There is a huge body of international research dedicated to effects of ownership concentration on corporate governance. One of the notable approaches to address the issue is to use legal origin approach proposed by La Porta et al. (1999) who cover 371 firms in 27 wealthy countries between 1995 and 1997. They conclude that common law countries have much better investor protection than civil law countries due to fiduciary duty and judicial ruling. Judges in common law countries are expected to set the rules based on precedents and inspired by sense of fairness, whereas in civil law countries legislators set the rules, and judges are not allowed to go beyond them. As consequence, if an insider finds a way to perform self-dealing without breaking the rules he will not be punished by the law. In fact courts in civil law countries do not intervene in self-dealing transactions as they may have plausible business purpose. As an implication of weak investor protection in civil law countries La Porta et al. suggest that control has a great value because it facilitates large shareholders to expropriate more efficiently. Other research sees the problem from a different angle. Ownership concentration may act as a substitute to investor protection, because large shareholders have enough power and incentive to monitor management. We address these views in our further analysis.
La Porta et al. (2000) imply negative effects of ownership on corporate governance in their cross-country study that focuses on a sample of 4103 companies from 33 countries in 1989-1994. They find that companies in civil law countries have lower dividend payouts than companies in common law countries. This is due to the fact that firms in civil law countries have low investor protection and as a consequence high levels of ownership concentration, resulting in expropriation of minority shareholders by large owners. On the other hand companies in common law countries exercise good corporate governance practices, while corporate ownership is dispersed there. One of the most important implications of the study is that shareholders in common law countries are willing to accept lower dividends, if a company has high investment opportunities. Strong shareholder protection makes investors confident about their investment, and thus they are willing to postpone dividends and reinvest them into new projects. Shareholders in civil law countries would typically try to extract maximum dividends regardless of investment opportunities of the company. La Porta’s et al. (2000) findings are illustrated in the Figure 2.

Low dividend payouts may lead to agency problem, when extra cash is not disgorged to shareholders, but stays at company management’s disposal and might be spent on projects destructing shareholder value.

On the contrary some research of corporate governance suggests that ownership concentration can have a positive effect on company’s governance practices. According to Shleifer and Vishny (1997) high concentration of ownership gives a
large shareholder an incentive to exercise control over company’s management and therefore prevent any abuse of managerial power.

Zeckhauser and Pound (1990) use a sample of 286 US firms from 22 industries in 1988 and prove empirically that large shareholders have a positive effect on company performance and corporate governance. However, for the U.S. companies presence of a large shareholder has no effect on dividend payouts.

Some prior research addresses a free rider problem. Grossman and Hart (1980) prove theoretically that when a company has a dispersed ownership, it is difficult to implement a takeover in case the company’s management is doing bad work. Minority shareholders would not tender their shares to a possible raider because they expect improvements to happen and their share value to increase. In other words minority shareholders would try to free ride on the improvements brought by the raider and, thus decrease his value. (Grossman & Hart 1980.) Ownership concentration should mitigate this problem, as a large shareholder should not allow poor management into the company in the first place or can easily implement a management turnover himself. High ownership concentration gives large shareholders an incentive and sufficient power to exercise shareholder rights and to control managers and, therefore if not totally prevent agency problem, but reduce agency costs significantly.

Recent research reveals non-monotonic effects of ownership concentration on corporate governance and company performance. Positive wealth effect and negative entrenchment effect are addressed specifically for insider ownership and largest shareholders by Gugler et al. (2008) with their sample of 6904 companies from the US, UK and continental Europe in 1989-1997. Wealth effect of insidership basically means a positive effect which is an increase in wealth of an insider as a shareholder. An entrenchment effect is a negative effect of insidership as it is. Higher insidership makes a takeover less probable and causes management entrenchment. Once managers possess 50 % of shares in a company, it is impossible for outsiders to remove them. Gugler et al. link company’s investment performance and insider ownership in the US companies, English-origin non-US companies and companies in civil law countries. They also distinguish between different types of owners. As a result the researchers find that significance of wealth effect of insidership over its entrenchment effects is strongest in the US and weakest in civil law countries. The
entrenchment effect is strongest in civil law countries. The same result holds also for the largest shareholder regardless his identity. In general the findings support the classical view that Anglo-Saxon countries provide a better protection against the agency problem than civil law countries. (Gugler et al. 2008.)

Truong and Heaney (2007) give special attention to the identity of the largest shareholder. Based on their cross-country research of 8279 listed firms from 37 countries in 2004 they conclude that the largest shareholder plays a significant role in company’s corporate governance and has some influence on firm’s dividend policy. There is evidence that the greater shareholding of the largest shareholder leads to higher dividend payouts. The relationship is convex, implying that at lower levels of large holding benefits of private control outweigh dividends. When the scale of large holding increases, the costs of entrenchment increase, as well as monitoring benefits of dividends. Also minority shareholders might compensate the large shareholder for increased monitoring costs in form of increased dividends. However, if the largest shareholder is an insider or financial institution the dividend payouts are lower. An insider shareholder may try to increase the cash flow under his discretion by adopting low dividend payouts, while high monitoring ability of a financial institution may act as a substitute for dividends. Interestingly there is some evidence that relationship of largest shareholding and dividend policy is a two-way dependence. Higher dividends induce increased shareholding particularly for the largest shareholder. In overall largest shareholders have a significant effect on dividend policies. The finding supports the classical agency view that the largest shareholder may act as a substitute for dividends in mitigating agency costs. Dividend policies are also connected to the identity of the largest shareholder. (Truong & Heaney 2007.)

An interesting insight is brought by Andres (2008) who analyzes ownership effects on firm’s performance in 275 listed German companies. About 85 % of listed companies in Germany have at least one blocking shareholder with more than 25 % stake. That is very much like in Russia. The major conclusion of the study is that family owned companies, where family members are represented in management or on board, perform significantly better than companies with other type of block holders or dispersed ownership. It is, however, contradictive with the generalization of La Porta et al. (2000) who suggest that often family owned companies in civil law countries exhibit high levels of agency costs, when family member-insiders
expropriate minority shareholders. Though superior performance does not necessarily induce higher dividends, which were the focus in La Porta’s et al. study, Andres (2008) specifically concludes that families do not use their controlling position to expropriate minority shareholders. La Porta’s et al. paper is a cross-country study, while Andres focuses on German firms, and thus we understand that within the civil law countries different exceptions may appear. Further in the empirical part of this paper (4.2) we make an effort to compare dividend payouts in the Russian firms with those of the rest civil law countries as well as common law countries.

Yeh (2005) investigates ownership effects on firm value within 251 listed Taiwanese companies in 1998. The ownership structures in Taiwan are characterized by high ownership concentration and family control. The study reveals a positive incentive effect under higher ownership concentration level. However, cross-shareholding, enhancing control through participating in management and controlling boards of directors decrease firm value acting as a negative entrenchment effect. Though Taiwan is a civil law country, family ownership has the opposite implications comparing to those observed by Andres (2008) in Germany. We conclude that effects and implications of ownership concentration may vary significantly even between the countries of the same legal origin.

Denis et al. (1997a, b) find that independent block holding has a positive impact on corporate governance within their sample of 933 US firms in 1985. They suggest that companies with unaffiliated block holders are more sensitive to execute management turnover than companies with affiliated block holders. Management turnover is a crucial element of corporate governance, as it reduces the risk of management entrenchment and agency costs. An independent large shareholder has enough monitoring power on the one hand, and on another his incentives are aligned with those of minority shareholders. Independent block holding is thus a way to mitigate the agency problem and might work as a corporate governance mechanism also in the civil law countries.

Pergola and Verrault (2009) review prior research and focus on owner’s type and identity. Their findings imply that presence of a large shareholder can improve corporate governance practices only if his incentives are aligned with those of minority shareholders. Even then presence of a large shareholder does not always
result in stronger corporate governance structures. Pergola and Verrault conclude that broad owner classifications can lead to inaccurate results. For instance, unaffiliated large shareholder can play an effective monitoring role in a company and create benefit which is shared by all shareholders. On the other hand affiliated large shareholder can cause a negative effect on shareholder value, as his incentives are not perfectly aligned with those of minority shareholders. Pergola and Verrault suggest that a more detailed owner classification has to be applied and come up with a model presented in Table 2.

Table 2. Monitoring influence factors (Pergola & Verreault 2009).

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Investor Identity</th>
<th>Affiliation</th>
<th>Ownership Concentration</th>
<th>Potential Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional investor</td>
<td>Public and Index Funds</td>
<td>Diverse</td>
<td>-</td>
<td>Less Effective</td>
</tr>
<tr>
<td>Private momentum traders</td>
<td>Diverse</td>
<td>Affiliated</td>
<td>-</td>
<td>Non-value maximizing</td>
</tr>
<tr>
<td>Private value investors</td>
<td>Diverse</td>
<td>Affiliated concentration</td>
<td>-</td>
<td>Private benefits</td>
</tr>
<tr>
<td>Unaffiliated</td>
<td>Diverse</td>
<td>Affiliated concentration</td>
<td>-</td>
<td>Shared benefits</td>
</tr>
<tr>
<td>Individual</td>
<td>Diverse</td>
<td>Affiliated</td>
<td>-</td>
<td>Less effective</td>
</tr>
<tr>
<td>Block owner</td>
<td>Diverse</td>
<td>Affiliated concentration</td>
<td>-</td>
<td>No private benefits</td>
</tr>
<tr>
<td>Corporate</td>
<td>Diverse</td>
<td>Affiliated concentration</td>
<td>-</td>
<td>Private benefits</td>
</tr>
<tr>
<td>Unaffiliated</td>
<td>Diverse</td>
<td>Affiliated concentration</td>
<td>-</td>
<td>Shared benefits</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>No shared benefits</td>
</tr>
</tbody>
</table>

The model employs four characteristics to assess a large owner’s role in corporate governance of a company. These are owner type indicating whether it is institutional investor or other block owner, owner identity, affiliation, and ownership concentration indicating whether there are other blocking owners in the company or
not. Pergola and Verreault (2009) suggest that a large shareholder’s incentives are best aligned if the shareholder is an independent corporate block holder in a company with diverse ownership or independent institutional investor from the private sector who exercises value strategies. These owners possess enough power to perform monitoring function and their incentives are best aligned with those of small shareholders. This view supports the prior research of Denis et al. (1997a, b) who suggest that independent block holding has a positive impact on corporate governance in the US firms. On the contrary Pergola and Verreault (2009) conclude that public and index funds, as well as individual block holders are less effective in performing monitoring function. Public funds are compensated differently than private, and may focus more on social and governance improvements, whereas individual block holders with some exception do not have sufficient power to perform monitoring efficiently comparing to corporate block holders. In general, the model emphasizes the necessity to consider detailed specification of owner classification when analyzing effects of ownership concentration on firm performance or corporate governance.

To sum up ownership concentration has complex effects on corporate governance and firm performance. A common feature for the most of the studies is that a low level ownership concentration causes negative entrenchment effect, usually decreasing firm performance, firm valuation or dividends. Higher ownership concentration induces positive incentive effect. However, the study of Gugler et al. (2008) stands out. The curves proposed by the study suggest that insidiership and ownership concentration produce a positive wealth effect at lower levels of insider holdings and ownership concentration and negative entrenchment effect at higher levels. Detailed owner classifications are worth employing in research as they provide a more accurate result. Large shareholders depending on their identity may have different incentives, and thus may influence corporate governance practices differently. For example, independent block holding can act as a corporate governance mechanism mitigating the agency problem. We also recognize that effects of ownership concentration may vary significantly even within the countries of the same law origin.
3.2. Effects of ownership concentration in the Russian companies

The Russian evidence regarding ownership concentration effects is not as rich as international one. The subject is quite new and fewer papers focus on it, which makes it worth researching. Levels of ownership concentration and especially insidership are extremely high in Russia (Table 3) and seem to have a great effect on corporate governance practices.

Table 3. Ownership structure in the Russian firms (Lazareva et al. 2007).

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2006</th>
<th># of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>average stake, %</td>
<td>median stake, %</td>
<td># of companies</td>
</tr>
<tr>
<td>Management</td>
<td>19,3</td>
<td>6,0</td>
<td>641</td>
</tr>
<tr>
<td>Largest outside blockholder</td>
<td>23,9</td>
<td>15,0</td>
<td>642</td>
</tr>
<tr>
<td>All small shareholders (&gt;5% stakes)</td>
<td>23,6</td>
<td>12,0</td>
<td>581</td>
</tr>
</tbody>
</table>

Ownership concentration has increased during Putin’s presidency. Table 4 indicates that percentage of firms with the largest shareholder’s stake over 24,99% increased significantly between 2002 and 2004.

Table 4. Ownership concentration during Putin's presidency (IFC 2003, 2005).

<table>
<thead>
<tr>
<th>Share of the largest shareholder in the company</th>
<th>2002, % of firms</th>
<th>2004, % of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% +</td>
<td>19</td>
<td>48</td>
</tr>
<tr>
<td>25% - 50%</td>
<td>23</td>
<td>27</td>
</tr>
<tr>
<td>0 – 24,99%</td>
<td>58</td>
<td>25</td>
</tr>
<tr>
<td>Number of firms</td>
<td>307</td>
<td>442</td>
</tr>
</tbody>
</table>

One of the most recent attempts to research ownership concentration effects in Russia is performed by Kuznetsov et al. (2008) whose data is based on management surveys and covers three years: 1999, 2001 and 2003. They agree that ownership concentration is one of the most distinguishing features characterizing Russian firms and define the following three attributes of the ownership structures in the Russian corporations:
• highly concentrated ownership (block-holding);

• block-owners seek for control by occupying managerial and board positions;

• insiders form the largest owner group among dominant shareholders.

Kuznetsov et al. (2008) emphasize the fact that ownership in the Russian corporations was captured mainly by insiders. Initially privatization was intended to create dispersed ownership structures like in the Anglo-Saxon countries by distributing company shares among employees. However, the management gradually succeeded to acquire the biggest stakes in the Russian firms, which resulted in highly concentrated ownership structures (Table 5).

Table 5. Ownership allocation in the Russian firms, % (Kuznetsov et. al. 2008).

<table>
<thead>
<tr>
<th>Year</th>
<th>1995</th>
<th>1997</th>
<th>1999</th>
<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007 (forecasted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insiders, total</td>
<td>54,8</td>
<td>52,1</td>
<td>46,2</td>
<td>48,2</td>
<td>46,2</td>
<td>46,6</td>
<td>54,0</td>
</tr>
<tr>
<td>Management</td>
<td>11,2</td>
<td>15,1</td>
<td>14,7</td>
<td>21,0</td>
<td>25,6</td>
<td>31,5</td>
<td>40,0</td>
</tr>
<tr>
<td>Employees</td>
<td>43,6</td>
<td>37,0</td>
<td>31,5</td>
<td>27,2</td>
<td>21,0</td>
<td>15,1</td>
<td>14,0</td>
</tr>
<tr>
<td>Outsiders, total</td>
<td>35,2</td>
<td>38,8</td>
<td>42,4</td>
<td>39,7</td>
<td>44,8</td>
<td>41,0</td>
<td>40,1</td>
</tr>
</tbody>
</table>

Kuznetsov et al. (2008) find that even these impressive figures do not reveal the whole truth about managers’ stakes in the Russian companies. Due to the secretive nature of corporate governance in Russia, a huge portion of stakes is owned through pyramidal ownership structures or employing outsiders as a façade, which makes it difficult to observe the actual owners of the companies.

Further Kuznetsov et al. discuss the ways in which large shareholders would attempt to extract private benefits of control. They divide them into two broad groups. The first group deals with amenity potential and can be described as non-pecuniary benefits resulting in social prestige from running a big company. These benefits do not come at expense of profits. The other way to extract private benefits is defined as tunneling which is using control of a firm to divert its cash flows. This may vary from third party related transactions to outright theft and is only possible in countries where no adequate investor protection and law enforcement are established. Tunneling may result from undeveloped capital markets, when market share prices
are difficult to realize due to low liquidity, which then pushes large shareholders to capture returns by expropriating minority shareholders.

Kuznetsov et al. (2008) set two hypotheses regarding ownership effects in the Russian firms. The first one suggests that ownership concentration has a negative effect on firm performance in transition economies. The second implies that a larger stake of the second largest shareholder would result in a better company performance. Both hypotheses hold for the Russian companies. Kuznetsov et al. conclude that large shareholders in transition economies would tend to expropriate minority shareholders due to undeveloped capital markets, which would not provide enough incentive for creating long-term value. Low investor protection and law enforcement would allow expropriation to happen. The view was earlier proposed by Pappe (2002), who finds that the only way to realize the market value of the Russian companies is to trade the shares on international stock exchanges. However, this tool is out of reach of the majority of the Russian firms. The second broad conclusion is that a coalition mechanism can be an effective instrument to mitigate agency costs. Several large shareholders would monitor each other and management more efficiently than one. Multiple non-CEO controlling shareholders may act as a substitute for independent board members (Brunello et al. 2003). Also Bennedsen and Wolfenzon (2000) find that the coalition of owners internalizes the costs of their actions, resulting in less costly private benefits they would extract.

Prior to Kuznetsov et al. (2008) Lazareva et al. (2007) suggest that the classical conflict of management and owners in not the case in Russia. Instead there is a huge conflict between large and small shareholders as well as a conflict between shareholders and outsiders called raiders. The value of control is extremely high in countries with low investor protection and legal enforcement. Corporate control allows large shareholders to expropriate minority owners more efficiently.

Filatotchev et al. (2001) employ a sample of 150 Russian privatized manufacturing firms from 1999 to analyze effects of ownership concentration on company investment and performance. One of their major conclusions is that ownership concentration creates a bad incentive leading to expropriation of minority shareholders by controlling party and it may also have a negative impact on company performance. There are different ways of how controlling shareholder can abuse the rights of minority shareholders in a Russian company. Filatotchev et al. suggest the
following types of expropriation employed by controlling shareholders in the Russian companies in the 1990s:

- **Share dilution**, when share of minority shareholders in a company is diluted through questionable schemes strengthening the position of a controlling shareholder at the same;
- **Pyramids of cross-shareholdings**, when companies at the bottom of pyramids can be poorly managed because of the lack of incentive to maximize shareholder value;
- **Related-party transactions**, when management performs transactions with affiliated companies on conditions destructing shareholder value;
- **Transfer pricing**, when sales profits are diverted to companies affiliated with management or large shareholders;
- **Asset stripping** - diverting assets from the company to firms affiliated with management or other large shareholders.

Sprenger (2002) adds to this list and describes *delayed dividend payments*, when declared dividends are postponed significantly taking advantage of inflation and ruble devaluation. *Disinformation and outright deception* including preventing outside investors from taking seats on boards of directors, failing to notify shareholders about important corporate events like annual shareholder meetings, misreporting financial information and etc. are the ways to cut off minority shareholders from vital information. *Hostile bankruptcy* plausible due to loopholes in the bankruptcy legislation may be eventually aimed to strip off valuable assets to creditors or other companies. (Sprenger 2002.)

One of the most widely known cases took place in the 1990s (Lazareva et al. 2007), when Sibneft, an oil company, controlled by oligarch Roman Abramovich, would sell oil at a bargain price of $2.20/barrel to Runicom, which would resell then the oil at the market price that was several times higher. This is often referred as transfer pricing. Runicom was affiliated with the main shareholder of Sibneft Roman Abramovich, and thus the latter was able to pump out profits from Sibneft to Runicom causing losses to the minority shareholders of Sibneft. Another case deals with a well-known Russian businessman-prisoner Mikhail Khodorkovsky a former CEO of Yukos, who was accused of setting up a transfer
pricing scheme between his affiliated companies. The use of transfer pricing as a way of extracting profits by a controlling shareholder was widely used in the Russian oil industry. However, Mikhail Khodorkovsky was probably the only publicly known oligarch who got in jail on this sort of charges, while many others did the same and managed to avoid prosecution. Apparently some political motives like financing the Russian political opposition and public critics of president Putin were to play role in the prosecution of Khodorkovsky. In the case of Yukos, though it was probably politically motivated, the agency costs for company’s shareholders were extremely high. Somewhat half of the company’s assets were sold through a very questionable scheme to state-owned Rosneft at a price well below Yukos’ market capitalization at that time. Yukos's assets in the beginning of the process were worth 477 billion rubles ($17.7 billion). Later the company faced tax charges that amounted 497 billion rubles and, as a result, was declared bankrupt. Hence, the other reason, why transfer pricing might be used in companies, is tax avoidance. This, as we see, may cause serious legal consequences to a company exercising it and huge losses to its shareholders. In case of Yukos, the shareholders literally lost the company’s assets to the Russian state.

Further Filatotchev et al. (2001) find that ownership concentration may also lead to a low level of investments. They reveal the high levels of correlation between concentration of ownership in the Russian privatized companies and their level of investments. The relationship is negative and significant. Filatotchev et al. also conclude that there is a relationship between the levels of concentration of ownership and the firm’s performance. In particular, they discovered that concentration of ownership negatively affects company’s capacity and labor utilization rates. Interestingly this relationship is non-monotonic being at its strongest with the lowest levels of blocking ownership. On the opposite this relationship might be weaker at the highest levels of controlling, implying that the bigger the cash flow controlled by large shareholder the more he is interested in an efficiently performing company. As a result, minority shareholders of companies with high levels of blocking ownership would suffer less from inefficient management than those of companies with low

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4 Data according to Yukos's court-appointed manager Eduard Rebgun. The Yukos’s management however valued the company’s assets as high as $38 billion. Source - Bloomberg’s publication by Lucian Kim and Bradley Cook - July 25, 2006
level of blocking ownership. This may result from the fact that a strong shareholder should restrain managerial opportunism and, thus reduce the levels of agency costs.

Lazareva’s et al. (2007) and Filatotchev’s et al. (2001) studies are supported by the prior research of Kuznetsov and Muravyov (2001) who conclude that in case of Russia agency problem in its classical interpretation of a conflict between professional managers and shareholders is not relevant. It rather would be a conflict between strong and weak shareholders. According to Kuznetsov and Muravyov (2001) high concentration of ownership may cause some negative effects on company performance. A controlling shareholder would try to maximize his own value through his high decision power and, thus reduce residual value shared by minority shareholders. This type of behavior of large shareholders is often referred to as extraction of private benefits of control (Barclay and Holderness, 1989).

Other research connects ownership concentration and company transparency. Zasada (2005) employing a sample of 82 Russian firms in 2002-2003 finds that dispersed ownership contributes to better transparency in the Russian companies, and therefore improves corporate governance practices, while ownership concentration reduces transparency of company reporting. According to Zasada’s findings ownership concentration is a negative factor in terms of corporate governance in the Russian firms.

Liljeblom and Maury (2008) employ dividend payouts to analyze effects of ownership concentration on corporate governance in 116 Russian companies during 1997 - 2003. They find an adverse effect of ownership concentration on dividend policies in the Russian companies. The researchers indicate that the control problem exists and minority shareholder expropriation is present. Liljeblom and Maury (2008) suggest that if a controlling shareholder is other than the state, then ownership concentration has a negative effect on probability of dividend payments in the Russian corporations. Foreign ownership, cross listings on international stock exchanges and international accounting standards seem however to mitigate the problem. Cross-listed companies are the subject to more stringent corporate governance policies and have to comply with the international accounting standards. Also foreign investors may require higher corporate governance standards in order to
invest in a company, or having enough voting power they can implement reforms aiming at shareholder value maximization.

Lazareva et al. (2007) suggest that if a controlling shareholder is not a manager himself, his incentives are better aligned with those of minority shareholders, meaning that share value maximization is the first priority. One of the important conclusions of Lazareva et al. (2007) is that ownership concentration is the second best option in countries like Russia, where weak legal protection and law enforcement take place. This is in line with the findings of Schleifer and Vishny (1997) who suggest that large shareholders have enough power and incentive to monitor company management. Also Truong’s and Heaney’s (2008) cross-country findings suggest that large ownership may lead to higher dividends, but not if insider is the largest shareholder. The insider would try to maximize cash flows under his discretion by adopting low dividend policies. In Russia ownership concentration may act as a substitute to investor protection and legal enforcement.

Maury and Liljeblom (2009) on the base of the data about of 121 companies between 1998 and 2003 conclude that the Russian companies owned by oligarchs went through valuation increase after year 2000. The result is supported by the previous research of Guriev and Rachinsky (2005) who analyze a sample of 627 largest owners of the Russian business groups. They find that productivity growth in oligarch companies was significantly higher than in other domestic companies in the year 2002, but not during the previous years. These researches suggest that the change of political regime (transition from Yeltsin’s to Putin’s period) led to lower political risks in Russia on the one hand and high natural resource prices on the other gave oligarchs incentive to better corporate governance practices and maximization of companies’ valuation. These findings do not contradict with the results of Filatotchev et al. (2001) who analyzes the financial data of 120 unquoted Russian companies in the 1990’s and suggest that high ownership concentration is negatively correlated with company performance. In the 1990’s it probably did take place. However, the oligarch companies started to perform better during Putin’s time of political stability and economic growth. This idea is also supported by Boone and Rodionov (2002) who suggest that oligarchs initially expropriated minority shareholders, diluted their share and gained a strong control over the companies.
Afterwards, they focused on maximizing company market value and managed to build up well performing businesses. The same implication may be derived from the empirical research of Maury and Liljeblom (2009), who find lower valuations of oligarch firms compared to non-oligarch during the Yeltsin period, and then indicate a reversal during the Putin period. They also discover that ownership concentration increased significantly after the Putin had become president, which supports the conclusions of Boone and Radionov (2002).

However, Maury and Liljeblom (2009) conclude that political risk was not the only factor affected valuations of the Russian firms, but also increased cost of stealing played a significant role. Improved legal enforcement made harder for the controlling shareholders to expropriate the small ones.

To sum up, the existing research emphasizes the fact that ownership concentration is a typical feature of the Russian economy. Controlling shareholders tend to occupy board and managerial positions in order to establish full control over the companies. Controlling shareholders are dominated by insiders, among which managers succeeded to acquire the biggest stakes in the Russian firms. Many researchers agree that, the agency problem in Russia is not that classical conflict between professional managers (agents) and company’s shareholders (principals) as in Anglo-Saxon countries, but rather a conflict between large and minority shareholders. This conflict occurs as extracting of private benefits of control by controlling shareholders. Concentration of ownership can also badly affect company performance, mainly due to the same reason that a large shareholder would try to extract profits before pro rata distribution and, thus reduce the residual value distributed among minority shareholders. Or according to alternative scenario, a controlling shareholder would rather be engaged in a furious fight with other shareholders over the control of a company than in building up an efficiently performing firm, or he would simply try to strip off the assets of a company. Indeed, such scenario was very typical for the 1990s. Later in the 2000’s oligarch companies started performing even better than the companies with different type of ownership structure mainly due to improved legal environment and political stability. Of course, the explanation could be that in the 1990s the oligarchs struggled to gain strong control over the companies, increased the share of the cash flow they were entitled to, and then in the 2000s they
had a better incentive for maximization of the long-term value. This incentive was supported by high prices on energy and natural resources, as well as by the need to expand the business and establish good reputation among outside financiers. The development of capital markets in turn have contributed to better corporate governance by creating better incentives to long-term value maximization.

Also ownership structures with multiple large shareholders and independent block holding have become very effective in mitigating agency costs, when each large shareholder has enough power and incentive to prevent extraction of private benefits by the other controlling shareholder. Together they can also perform management monitoring more efficiently.
4 EMPIRICAL RESEARCH: OWNERSHIP CONCENTRATION EFFECTS ON CORPORATE GOVERNANCE IN THE RUSSIAN FIRMS

In our empirical research we focus on analyzing effects of ownership concentration on corporate governance in the Russian corporations. Our hypothesis is that ownership concentration has a negative impact on corporate governance in the Russian firms. We employ dividend payouts as a measure for corporate governance practices. Higher dividend payouts would typically mean better corporate governance. La Porta et al. (2000) find low dividend payouts for civil law countries, where investor protection is low, and higher dividends in common law countries, where shareholder rights are believed to be protected the best. La Porta et al. (2000) emphasize that high ownership concentration is typical for civil law countries, where minority shareholders would be typically expropriated by controlling shareholder. On the other hand they suggest that high dividend payouts in common law countries are an outcome of good shareholder protection, indicating that dividend policies might be associated with corporate governance practices. Low dividends in absence of investment opportunities may also indicate an agency problem. Cash holdings staying at disposal of managers might be spent on projects destroying shareholder value (La Porta et al. 2000, Liljeblom & Maury 2010). High dividend payouts reduce risk of agency problem. Mitton (2004) researches emerging markets and finds strong relationship between corporate governance practices and dividend policies among 365 companies in 19 countries. Better firm-level corporate governance and additionally stronger country-level investor protection are associated with higher dividend payouts. The result is also applicable for broader sample. On the base of prior research we conclude that dividend payouts may serve as a proxy for corporate governance practices, though not a perfect one. Dividend payout ratios are easy to use in research as they are observable while other accounting measures might be a subject for earnings management, manipulation or falsification.

There has been done some research on relation of company ownership structure and dividend policies. For instance, Maury and Pajuste (2002) find negative relation between controlling ownership and dividend payouts in Finland, which is a civil law country. Guriev and Rachinsky (2005) observe superior performance of the oligarch firms in Russia in 2002. Liljeblom and Maury (2008) conclude that majority
ownership other than by the state has adverse effect on dividend payment probability in the Russian corporations during 1997-2003. Zeckhauser and Pound (1990) find that presence of a large shareholder provides higher earnings growth, but has no effect on dividend payouts in the American companies. Truong and Heany (2007) conclude that large shareholders affect dividend policies. In particular the researchers support a classical agency view that a large shareholder can be a substitute for dividends mitigating agency problem.

Inspired by the prior research we try to capture possible impacts of ownership concentration on dividend payouts in the Russian companies, if such a relationship is present in the first place. Controlling ownership is very typical for Russia and understanding of its effects on corporate governance is thus very important.

4.1. Dividend payouts by legal system

In this section we analyze dividend payout ratios by law origin to test the hypothesis set by La Porta et al. (2000). Companies in the common law countries would have higher dividend payouts, which are explained by stronger investor protection (outcome model). The alternative hypothesis is that companies in civil law countries would pay higher dividends to compensate minority shareholders for low shareholder protection (substitute model). To test this hypothesis we use a dataset from the Worldscope database. After deleting missing observations of dividend payout ratio we have a set of 56 countries, 50,145 companies and number of observations 418,435 over the period 1983-2011. Deviating from the La Porta’s et al. approach we do not exclude countries with mandatory dividend policies as we consider that national legislation is a part of investor protection. Actually many issues related to investor protection are regulated by legislation also in common law countries. Especially, in the light of the findings of La Porta et al. (1999, 2000) who attributes corporate governance to the legal origin of countries, we see excluding of civil law countries with mandatory dividend policies from the sample as a contradictive logic at least to some extent.

We set a dummy variable LAW, which indicates if a country is a civil law (LAW = 1) or common law (LAW = 0) country. This variable is a proxy for level of protection of shareholder rights, which is low in civil law countries and high in
common law countries. Then we run t-tests to find any significant difference in DIV variable (dividend payout ratio) of civil and common law countries.

### Table 6. Dividend payout ratios by legal origin.

<table>
<thead>
<tr>
<th>Legal system</th>
<th>N</th>
<th>Mean</th>
<th>Std Dev</th>
<th>Std Err</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common law (0)</td>
<td>207314</td>
<td>15.9918</td>
<td>24.4870</td>
<td>0.0538</td>
<td>0</td>
<td>100.0</td>
</tr>
<tr>
<td>Civil law (1)</td>
<td>211121</td>
<td>21.8949</td>
<td>25.3774</td>
<td>0.0552</td>
<td>0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

The results in Table 6 are contradictory with La Port’s et al. (2000) who support the outcome dividend model. This contradiction to La Porta’s et al. (2000) findings may result from our bigger data set. We use a longer time period than La Porta et al. (2000). We also do not exclude countries with mandatory dividend policies. However, even excluding countries with mandatory dividend policies does not affect our results significantly. Our finding is also supported by prior research of Truong and Heaney (2008) who report DivI (Ratio of total dividends to net earnings after tax before extraordinary items) mean for the civil law countries 28.81 % and for the common law countries 19.85 % in 2004. Our results advocate the substitute dividend model according to which companies in civil law countries would pay higher dividends than in common law countries as a substitute for investor protection (Figure 3). The model implies that companies in civil law countries would pay higher dividends when they have investment opportunities in order to establish good reputation on the capital market.

![Figure 3. The substitute dividend model (La Porta et al. 2000).](image-url)
4.2. Russia’s dividend payouts vs. other civil law countries

Further we compare dividend payout ratios of the Russian corporations with the companies of other civil law countries. For this purpose we apply t-test with a dummy variable RUS (Russia = 1, other civil law country = 0). The sample is restricted to the civil law countries only, otherwise is the same as in 4.1. The findings in Table 7 reveal that dividend payout ratios in Russia are significantly lower comparing to other civil law countries - average 5.30% in Russia against 22.14% in other civil law countries. This fact may imply a severe agency problem in the Russian corporations. Shareholders are not able to extract dividends and, thus we conclude that investor protection is weak and companies exercise bad corporate governance practices. This result is supported by Ruzhanskaja and Luk’ianov (2011) who find extremely low dividend payouts in the Russian companies. In 2006 up to 90% of joint-stock companies refrained from regular dividend payments, causing numerous corporate conflicts.

<table>
<thead>
<tr>
<th>Rus. / Civil</th>
<th>N</th>
<th>Mean</th>
<th>Std Dev</th>
<th>Std Err</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Civil law (0) (excl. Russia)</td>
<td>208048</td>
<td>22.1400</td>
<td>25.4250</td>
<td>0.0557</td>
<td>0</td>
<td>100.0</td>
</tr>
<tr>
<td>Russia (1)</td>
<td>3073</td>
<td>5.2992</td>
<td>14.1842</td>
<td>0.2559</td>
<td>0</td>
<td>99.8361</td>
</tr>
</tbody>
</table>

4.3. Dividend payouts vs. ownership concentration in the Russian corporations

In this section we analyze if high ownership concentration affect dividend payout ratios in the Russian corporation. The idea of this analysis is to reveal if large shareholders do actually expropriate minority shareholders in a form of low dividends. We use the same data sample from the Worldscope database. We extract all the Russian companies for the analysis and delete all the missing or nonsensical values of Closely Hold Shares (CHS) and Dividend Payout Ratio (DIV) -variables. After adjusting the sample we have 833 observations of 209 companies. The time
period is 1993-2011. In the analysis we apply OLS regression with an independent variable CHS – Closely Held Shares which includes, but not restricted to:

- Shares held by officers, directors and their immediate families
- Shares held in trust
- Shares of the company held by any other corporation (except shares held in a fiduciary capacity by banks or other financial institutions)
- Shares held by pension/benefit plans
- Shares held by individuals who hold 5% or more of the outstanding shares;

The variable DIV is the same as in section 4.1.

The companies are sorted into 3 groups by CHS as follows (Table 8):

CHS1, if CHS < 20 % (the reference group)

CHS2, if 20 % <= CHS < 50 %

CHS3, if CHS >= 50 %;

<table>
<thead>
<tr>
<th></th>
<th>CHS1</th>
<th>CHS2</th>
<th>CHS3</th>
</tr>
</thead>
<tbody>
<tr>
<td>N of companies</td>
<td>13</td>
<td>33</td>
<td>202</td>
</tr>
<tr>
<td>N of observations</td>
<td>21</td>
<td>59</td>
<td>753</td>
</tr>
</tbody>
</table>

The descriptive statistics in Table 8 outlines the fact that corporate ownership is highly concentrated in Russia. A strong majority of companies has CHS over 50 %.

The results in Table 9 show strong relationship between dividend policy and ownership concentration.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>1.15938</td>
<td>4.21608</td>
<td>0.27</td>
</tr>
<tr>
<td>CHS2</td>
<td>13.01530</td>
<td>4.90940</td>
<td>2.65</td>
</tr>
<tr>
<td>CHS3</td>
<td>10.72279</td>
<td>4.27447</td>
<td>2.51</td>
</tr>
</tbody>
</table>

CHS1 is a reference group

Our hypothesis that ownership concentration has a negative impact on corporate governance does not hold. Existence of a large shareholder/-s in a company seems to provide higher dividend payouts in the Russian corporations. This might be explained by large shareholders’ high incentives and availability of resources to monitor and control the company (Shleifer & Vishny 1997). A strong shareholder should restrain managerial opportunism and, thus reduce the levels of agency costs (Filatotchev 2001). Alternative explanation is that a large shareholder would compensate minority shareholders for holding shares in the company as the substitute dividend model suggests (La Porta et. al. 2000). Large shareholders in the Russian companies would use high dividend payouts to signalize better corporate governance practices and company’s quality. If so, the substitute dividend model holds. These two explanations do not contradict with each other, but rather complement. The large shareholder has enough power and incentive to monitor the management efficiently and probably acts as a substitute for investor protection mitigating possible agency costs.

4.4. Yeltsin’s vs. Putin’s period

Liljeblom and Maury (2009) find that oligarch-owned companies have better valuations in Putin’s period than during Yeltsin’ period. They explain the finding by improved corporate governance, which resulted from political stability and the cost of stealing being too high during Putin’s time. They also suggest that concentrated ownership along with low political risks during Putin’s time aligned oligarchs’ incentives better with those of minority shareholders. Also increased oil and gas
prices had impact on dividend payouts. Guriev and Rachinsky (2005) agree that oligarch were significantly more productive than other domestic companies in the year 2002, but not during the previous years.

In this section we test if there any significant difference in dividend payouts in the Russian companies during Putin’s and Yeltsin’s periods. Companies with better corporate governance would tend to pay higher dividends. Also companies with superior performance are more likely to have higher dividend payouts comparing to less productive firms. Therefore, our test is either to support or argue with the findings of Liljeblom and Maury (2009), Guriev and Rachinsky (2005).

First, we divide companies in two groups by presidential period. Then we run an OLS-regression, where DIV is dependable variable, and PD is a dummy variable indicating either Yeltsin’s (PD = 0) or Putin’s period (PD = 1).

Table 10 Dividend payouts vs. presidential period in the Russian companies.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>4.27491</td>
<td>2.87858</td>
<td>1.49</td>
</tr>
<tr>
<td>PD</td>
<td>7.92757</td>
<td>2.95963</td>
<td>2.68</td>
</tr>
</tbody>
</table>

The results in Table 10 support the findings of Liljeblom and Maury (2008) who report significantly higher dividend payout ratios in the Russian firms in 2003, than in 1998. Also the finding is in line with research of Liljeblom & Maury (2009), and Guriev & Rachinsky (2005). The Russian corporations have been paying higher dividends during Putin’s period than in Yeltsin’s time. Though we do not regress the dividend payouts versus ownership concentration, it is clear that oligarch companies represent the majority and they contribute a lot to the coefficients mentioned above. However, further we try to run the tests as in 4.3 employing CHS-variable separately for two samples: Yeltsin’s and Putin’s period.
Unfortunately we have to skip further tests with the sample for Yeltsin’s period due to a low number of observations for CHS1 and CHS2 groups (Table 11). Otherwise the results would be inconclusive and would not create any significant scientific value. However, we are able to do the tests for Putin’s period (Table 12 and Table 13).

Coefficients in Table 13 show a strong positive relationship between the dividend payouts and ownership concentration in the Russian companies during Putin’s period. Our hypothesis that ownership concentration leads to minority shareholder expropriation fails again. This finding strongly supports that of Liljeblom and Maury (2009) suggesting that lower political risks, properly aligned incentives of controlling shareholders and high cost of stealing led to better governance practices and higher company valuations during Putin’s time. High dividend payouts are associated with higher shareholder protection (La Porta 2000). In civil law countries like Russia majority shareholders would compensate minority shareholders for holding risks (low investor protection). If that is the case, then the substitute dividend model
applies (La Porta 2000). This explanation would be also in line with the findings in 4.1 indicating higher dividend payouts in the civil law countries.

4.5. Robustness of results

To verify the robustness of the results we run the tests for the sample which excludes the firms having only one observation. The sample contains 799 observations for 175 firms. We report the following results (Table 14).

Table 14. Dividend payouts vs. CHS in the Russian companies excluding companies with only one observation.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>1.28142</td>
<td>4.43074</td>
<td>0.29</td>
</tr>
<tr>
<td>CHS2</td>
<td>13.03535</td>
<td>5.10514</td>
<td>2.55</td>
</tr>
<tr>
<td>CHS3</td>
<td>10.69760</td>
<td>4.48866</td>
<td>2.38</td>
</tr>
</tbody>
</table>

CHS1 is a reference group

Then we also exclude companies having only two observations resulting in a sample of 127 firms and 702 observations. We report the results in Table 15.

Table 15. Dividend payouts vs. CHS in the Russian companies excluding companies with only two observations.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Parameter Estimate</th>
<th>Standard Error</th>
<th>t Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.80792</td>
<td>4.94880</td>
<td>0.16</td>
</tr>
<tr>
<td>CHS2</td>
<td>13.07058</td>
<td>5.68573</td>
<td>2.30</td>
</tr>
<tr>
<td>CHS3</td>
<td>11.99047</td>
<td>5.01056</td>
<td>2.39</td>
</tr>
</tbody>
</table>

CHS1 is a reference group

We conclude that our results are robust and the model holds also when excluding companies with irregular dividend policies.
4.6. **Summary of results**

Our findings related to the cross-country sample support the substitute dividend model. The result is contradicitive with the outcome model of La Porta et al. (2000). Our conclusion on this part is that companies in civil law countries would pay higher dividends as a substitute for investor protection and to establish reputation on the capital markets.

We find significant probability of minority shareholder expropriation in the Russian companies, as the dividend payout ratios are much lower than in other civil law countries on average. However, the expropriation is not caused by ownership concentration though we do find significant dependence of the dividend payouts on ownership concentration in the Russian corporations. The coefficients are significant and positive indicating positive effect of ownership concentration on dividend payouts. The results hold for the whole sample and Putin’s period. The sample restrictions did not allow us to perform the tests for Yeltsin’s period.
5 CONCLUSION

In this paper we performed a research of corporate governance and agency problem in Russian. In the beginning we suggested the framework for analysis of corporate governance in Russia. Further on the basis of the framework we analyzed the current state and development of corporate governance in the country. In this work we refer to the prior theoretical research on corporate governance and the agency theory, and also to empirical evidence related to Russian firms. The main conclusions are that the classical AT is not an appropriate framework to be used for corporate governance analysis in Russian corporations, but the SAT should be applied instead. The SAT is a better choice for the reason that it takes into consideration relationships of different stakeholders in a company, while the AT basically deals with the principal-agent relationship, which is of purely financial nature. SAT is applicable for the civil law countries while the classical AT for the common law countries.

The main body of our research is dedicated to ownership concentration effects on corporate governance in the Russian corporations. We conclude that the main conflict is expropriation of minority company owners by large shareholders. The classical interpretation of agency relation between owners and management is not relevant in the Russian case. Based on the prior research we find severe expropriation of minority shareholders especially during the 1990s. International evidence suggests that different owner types affect corporate governance, dividend payouts and company performance differently. We recognize that effects and implications of ownership concentration may vary greatly within the countries of the same legal origin. Major conclusion is that if large shareholder’s incentives are aligned well with those of minority shareholders, he performs a monitoring role in a company and may act as a substitute for investor protection mitigating possible agency costs.

The Russian evidence suggests that high concentration of ownership in the Yeltsin period caused expropriation of minority shareholders by large ones. This resulted in low valuations of the Russian companies. However, later political stability of Putin’s time improved corporate governance practices and made stealing too expensive. The change resulted in drastic increase of market capitalization of the Russian firms. Also
cross-listings on Western stock exchanges, ownership structures with multiple large shareholders, independent block holding and foreign ownership help to mitigate agency costs.

In our empirical research we focused on analysis of ownership effects on the dividend payouts in the Russian companies. It is obvious that agency costs borne by shareholders are high in the Russian firms, as we find the dividend payouts to be very low comparing to other civil law countries. However, our research does not support the idea that ownership concentration would lead to expropriation of minority shareholders. There is a significant positive relationship between levels of ownership concentration and dividend payout ratios in the Russian firms. We argue that ownership concentration is probably the best way to secure good corporate governance practices in Russia, where low investor protection and weak law enforcement prevail which is line with Lazareva’s et al. 2007 conclusions. Ownership concentration may act as a substitute for investor protection. Large shareholders have better incentives and resources to monitor and control management (Shleifer & Vishny 1997). Their incentives are better aligned with those of minority shareholders and share value maximization is a priority for them. Ownership concentration also reduces agency problem induced by free rider effect. Alternative explanation is that large shareholder would compensate minority shareholders with high dividends as a result for low investor protection and in order to establish reputation on capital markets (La Porta et al. 2000, Klapper & Love 2004).

The effects of ownership on corporate governance in the Russian companies are not unambiguous however. Zasada (2005) argue that dispersed ownership leads to better transparency in the Russian companies. Liljebloom & Maury (2008) find important identity of large shareholder when analyzing relationship of ownership concentration and dividend payouts. Different types of large shareholder may affect company’s dividend policy differently. Maury and Pajuste (2002) suggest that different owner types have different preferences for dividends due to agency problem or tax reasons in Finland. The same or similar implications may apply for Russia as well. Also Pergola and Verrault (2009) suggest that broad assumptions regarding large owner’s identity may lead to inaccurate results, and thus detailed owner classification should be used instead. Unfortunately, our sample does not allow capturing any effects of
different owner types on companies’ dividend policies. Therefore, we propose
detailed analysis of ownership effects on the dividend policies in Russia employing
owner specifications as a subject for further research. Especially effects of high level
of insidership should be addressed. However, this may turn out to be difficult, due to
the secretive nature of the Russian ownership structures that does not allow
observing all the real owners of the Russian firms. One should also consider
employing more sophisticated measures of corporate governance than dividend
payouts. Though there is some evidence that high dividend payouts can be associated
with good corporate governance practices, the measure still might be an imperfect
proxy for these purposes. One of the reasons is that the management in the Russian
companies can expropriate shareholders by delaying approved dividends (Sprenger
2002). In our research we cannot control for such imperfections. Another problem
with dividends is that we, as well as Truong and Heaney (2008), actually observe
highest dividend payouts in the civil law countries, which raises the question: Can
dividend policies be associated with the corporate governance after all? This is, if we
accept the fact that the common law countries should exhibit better corporate
governance practices, and therefore higher dividend payouts. Hopefully, future
research will be able to tackle these problems. One way to deal with the issue is to
employ direct measures of corporate governance, such as corporate governance
indices.
REFERENCES


