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**CORPORATE GOVERNANCE AND SHAREHOLDER
RIGHTS IN RUSSIA**

D. Willer

ABSTRACT

In an environment where shareholder rights cannot be enforced, management might choose to honour these rights out of self interest. This paper presents evidence from a sample of the 140 largest Russian joint stock companies, of which only a minority of firms do honour shareholder rights. These firms tend to have higher valuations on the equity market. On the other hand, the introduction of shareholder rights reduces the possibilities for management to steal. This paper develops a simple model and gives some empirical evidence on which firms are likely to choose to honour shareholder rights. In particular, I find that larger firms are more likely to honour shareholder rights, possibly because the expected value of stealing profits is smaller as the likelihood of punishment in the case of detection is higher. Furthermore, there is some evidence that large outside blockholders, as well as the state in its role as shareholder, are able to press for shareholder rights.

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1. INTRODUCTION

Russia privatised state-owned assets very quickly and allocated considerable amounts of shares to insiders (workers and management). The remaining shares were partly given away for free to the population (voucher-privatisation), partly remained with the state and partly sold to outside blockholders. While the Russian privatisation procedure led to a very fast privatisation, it also frequently resulted in dispersed ownership of shares. Since the owners of small share packages have little incentive to collect costly information to monitor management, many firms are essentially controlled by management. This can be problematic, as an unchecked management could be able to engage in asset stripping or the diversion of profits for personal consumption. The creators of the privatisation process were hoping that this problem would be mitigated over time. As workers or the population sell their shares, outside blockholders can come into existence or get stronger. Furthermore, by selling state owned shares directly to outside blockholders, the power of management would also be curbed. Voucher funds were also meant to exercise a role in corporate governance. For a very positive assessment of this privatisation process see, for example, Boycko *et al* (1995). However, in practice the role of outside blockholders has been restricted by the fact that management can choose not to honour shareholder rights of outside shareholders due to weak enforcement of the laws concerned. For example, by mid 1996 only 17% of the largest 140 Russian firms have complied with regulation that makes independent share-registries obligatory. In the latest instance of a violation of shareholder rights, 10% of the shares of Surgutneftegaz were issued and sold below market prices to the Surgut Holding company, which is controlled by insiders, in October 1996¹. Therefore it seems

necessary to analyse the issue of shareholder rights to be able to assess whether the optimism of Boycko *et al* is justified. La Porta *et al* (1996) examined the relation between protection of investors and the financing patterns observed over a cross-section of countries. Their main findings suggest that concentrated ownership can act as a substitute for strong legal protection of outside shareholders' interests. However, their paper says little about how this equilibrium outcome is reached. In this respect, the case of Russia is an interesting natural experiment, where directly after the privatisation process there were neither strong laws nor concentrated ownership. Nevertheless, it can be observed that the insufficient protection of outside shareholders is not a problem in every firm. It does seem to be the case that some firms start to honour shareholder rights, although it is only a minority among the 140 firms largest Russian firms (by sales) whose shares are traded on the over-the-counter market². This paper examines what determines whether a firm does honour shareholder rights. On the one hand it is shown that shareholder-friendly behaviour is reflected in a higher valuation of the firm in the equity market. On the other hand, the introduction of shareholder rights is likely to reduce the possibilities for management to steal. I find that an important determinant of good behaviour towards shareholders is size. Larger firms are more likely to honour shareholder rights (provide information to outsiders, use independent shareholder registries etc.), possibly because the expected value of stealing profits is smaller and the likelihood of punishment in the case of detection is higher. Furthermore, there is some evidence that the larger the stake of the outside shareholder, the more likely a firm is to honour shareholder rights. This would imply that some outsider shareholders push for shareholder rights. Lastly, there is some evidence that a larger size of the stake of the state is, *ceteris paribus*, associated with more shareholder-friendly behaviour. This would suggest that pressure by the state in its role as a shareholder also plays a role³. The only indicator of shareholder rights which is not positively correlated with the size of the largest outside investor or the stake of the state are dividend payments. They are also the only measure of shareholder-friendly behaviour which is

not positively correlated with all the other measures I use in this paper. This points to the fact that dividends are not used to signal that management is of a shareholder-friendly type and poses the question why dividends are paid at all in Russia.

It is worth noting that these problems are not specific to Russia. The 1995 International Finance Corporation (IFC) Factbook of Emerging Markets lists only 5 out of the 26 emerging markets it covers as having investor protection of an internationally acceptable quality. It also singles out the Chinese equity market of having especially poor investor protection. While this paper focuses on Russia in its empirical investigation, which had not been included in the last IFC ranking, the findings are relevant to other emerging markets as well.

This paper is organised as follows: Section 2 describes different indicators as to what extent the largest 140 Russian joint stock companies honour shareholder rights. Section 3 puts forward a simple model to analyse which firms are likely to honour shareholder rights. Section 4 describes the dataset used for the empirical examination. Section 5 uses this data to test the hypothesis of Section 3. Section 6 concludes.

2. SHAREHOLDER RIGHTS IN RUSSIA

In recent work Modigliani and Perotti (1996) have shown how the development of the equity markets in different countries depends on how well laws protect the property rights of minority shareholder. Furthermore, La Porta *et al* have shown that the legal set-up matters with respect to the ownership arrangement of joint stock companies. In countries where legal institutions are underdeveloped and where the enforcement of laws cannot be relied upon, it is not sufficient to analyse the legal framework when examining whether shareholder rights are honoured⁴. Instead, it is necessary to find indicators that reflect the actual behaviour of management towards outside shareholders. This is illustrated by a number of instances where shareholder rights have been violated in Russia although legislation

to remedy these problems had been in place, for example in the case of Surgutneftegaz mentioned in the introduction. In this section, several different indicators are proposed and data is presented for the 140 largest Russian open joint stock companies.

Shares give two different rights to its owners: rights of control and income-rights⁵. During transition, the more important feature of shares are arguably the control rights. This is true as the majority of privatised enterprises are in need of severe restructuring. During this period of restructuring, control rights matter even more than during 'normal' times because many long term, strategic decisions that can involve substantial sunk costs have to be made. Furthermore, to the extent that privatisation did not result in an allocation of control rights that facilitates restructuring, this shortcoming is to be mitigated in the secondary market. At the same time, income of firms is in many cases relatively low during transition but is expected to grow fast, such that income rights during the first years are of relatively little importance. This is reflected in the discount at which preference shares are traded (Table 1). Preference shares are shares that have been issued for free to employees by the firms that chose option 1 of privatisation (which roughly 25% did)⁶. These shares amount up to 25% of the chartered capital. They have no voting rights attached but are in general guaranteed preferential treatment with respect to dividend payments. The details of this preferential treatment vary across firms and are laid down in the corporate charters. Most of these charters state that 10% of after tax profits, or the equivalent to the dividend on ordinaries (whichever is greater), have to be paid out as dividends to shareholders of preferred shares.

Table 1 shows the change of the premium of ordinary shares over preference shares over time for some of the most liquid Russian companies, where data is available. This discount decreased for most of the firms substantially, for example in the case of LUKOil from 95% in October 1995 to 40% in September 1996. Of course, preferred shares in October 1995 were very illiquid and not many transactions have taken place at these prices. Since then liquidity has increased markedly. However, apart from the increasing liquidity of these shares the decrease in the premium is also likely to reflect the

fact that the prime importance of control rights is slowly decreasing in Russia as firms start to honour shareholder rights to a larger extent and regulatory progress is made⁷. Still, the premium remains very large, pointing to the importance for shareholders to participate actively in shareholder meetings and the management of the company in order to protect their investment. This interpretation is also consistent with the finding that this discount is small in the US (5%) and much larger in Israel (31%) and Italy (45%) — the latter two countries with much weaker protection of investors⁸.

Table 1
Premia of Ordinary Shares Over Preference Shares
as Percentage of Ordinary Share Price

Date	Rostelekom	UES	Lukoil	Surgut- neftegaz	Norilsk Nickel	Noyabrsk- neftegaz
2.10.95	95%	85%	88%	87%	62%	86%
10.1.96	93%	68%	83%	82%	57%	86%
1.4.96	68%	62%	70%	67%	29%	72%
3.7.96	56%	74%	65%	78%	62%	69%
26.9.96	41%	46%	40%	49%	50%	49%

Source: Prema-Invest

As income rights of equities are not codified in commercial law (it is in the nature of the equity contract that dividend payments cannot be enforced by a court), problems related to the difficulty of enforcing shareholder rights in Russia are mostly related to the control rights of shares. To examine to what extent managers honour control rights of shares, this paper focuses on the independence of shareholder registries, on the provision of information to shareholders and on whether American Depositary Receipts (ADRs) or similar instruments were issued. ADRs are certificates sold at an American securities exchange, denominated in USD, that are backed by shares that are held in custody in Russia. An issue of these instruments indicates that management does honour shareholder

rights to the extent that the costs of violating them increases if ADRs are outstanding. This does seem likely, as outstanding ADRs increase the likelihood of detection of stealing. It also would increase the likelihood of subsequent punishment, if one believes that the international financial community has some clout with Russian policy-makers.

Historically, the first issue of concern was the reliability of share registries. In particular, several well publicised instances occurred during 1994 and 1995, where management manipulated share registries or refused to register new shareholders⁹. Since share registries are the only proof of share-ownership in Russia, in effect this amounted to negating property rights of outside investors. Subsequently, several steps were taken to mitigate this problem: a presidential decree was introduced in 1995 which makes independent share-registries for firms with more than 1,000 employees obligatory. Based on this decree the FSC issued interim regulations on the maintenance of share registers in July 1995. These regulations determine how lawful entries in the share registries are to be made and also introduces a liability of the registrar for any improper performance of its duties. Furthermore, the need for share registries to obtain a license from the FSC is stated. By 30 August 1996, licenses to 104 share registries in 49 regions have been granted. Whether a firm uses a licensed share register is one of the indicators of shareholder rights this paper uses ('License'). By September 1996, 17% of the largest 140 Russian firms had their shares registered by a licensed share registry. A second indicator that relates to the same aspect of shareholder rights is based on a periodic survey carried out by "Agenstvo Konsultii i Marketing" (AK&M). In this survey, 308 participants in the Russian stock market (150 Moscow firms and 158 regional firms) were asked to name up to 5 companies for which they found it particularly easy to transfer the ownership of stock (in order of convenience)¹⁰. The answers were then used to calculate an index on the ease of ownership transfer ('Transfer')¹¹. This survey is likely to reflect similar issues as 'License'. As is to be expected, the two measures are significantly positively correlated (see Table 2). This seems to indicate that the

licensing procedure of the FSC is effective in the sense that licensed registries seem to involve lower risk of improper handling of entries than unregistered ones.

Another important aspect of shareholder rights is the provision of information on the company to shareholders. Information is necessary to evaluate the performance of management and to use the control rights of the shares in exercising corporate governance in a meaningful way. The importance of this point is stressed by a presidential decree of March 1996 which lays out a comprehensive program on investors' and shareholders' rights and demands higher disclosure requirements for firms¹². The recent struggle between outside investors, controlling 40% of the Novolipetsk Metallurgical Kombinat, and management, who refuses to provide meaningful financial statements to the investors, illustrates the problems inherent in this area¹³. This paper focuses on two different variables that measure this aspect. The first is a dummy variable that denotes whether a firm has had its accounts done according to International accounting standards ('IAS')¹⁴. This is important as Russian accounting is still based on the necessities of the state economy and consequently does not provide information that allows to evaluate firms according to a market environment. By January 1996 24% of the firms in the sample had (at least a partial) audit done according to IAS. In September 1996, the government decided to grant tax reductions for firms that would adopt these international accounting principles¹⁵. As a second measure, the 308 participants in the AK&M survey were also asked to name up to 5 firms that were particularly open about disclosing information to investors (in order of openness). The two measures are significantly positively correlated (see Table 2).

The issue of an insufficient provision of information is also relevant in other countries. The IFC Emerging Markets Handbook lists only 8 out of the 26 markets it covers as having accounting standards of an internationally acceptable quality. China and Indonesia have especially poor accounting standards. In Jordan there are not even interim financial disclosure requirements for the firms implemented.

Lastly, some firms issued ADRs, Global Depository Rights (GDRs) or Russian Depository Receipts (RDCs). ADRs are mainly of level 1, which can be traded on the New York Stock Exchange (NYSE) but are backed by shares the treasury of the firm hands over to the depository. In this sense, they do only allow firms to raise new capital in case the treasury owns some of the companies' stock. This is the case for many Russian firms as a result of the privatisation process. The buyer of an ADR is allowed to exercise the voting right of the underlying share. GDRs are essentially similar securities, traded at different stock exchanges. RDCs are also very similar certificates backed by Russian shares, held in custody by ING bank. To the extent that these instruments allow foreigners more easily to acquire Russian shares, this also indicates that management is shareholder-friendly. Furthermore, the probability of being punished for violating shareholder rights is likely to increase after ADRs have been issued. This is true as violations become more visible since the financial press will cover them more thoroughly. This, in turn, is likely to increase the political pressure on management to undo the violations¹⁶. By January 1996 10% of the sampled firms had issued one of these instruments. Issuing these instruments is positively correlated with the introduction of Western accounting. This is not very surprising, as most of the firms who issued level 1 ADRs plan to issue level 3 ADRs in the near future. For these type of ADRs 3 years of Western accounting is required by the NYSE¹⁷. Issuance of ADRs are also positively correlated with the other measures of shareholders' (control) rights.

For the analysis of income rights it is necessary to examine the dividend policy for ordinary shares of firms¹⁸. In 1993, 34% of firms paid dividends on ordinary shares and close to 100% on preferred shares. On ordinary shares dividends were quite small and at times paid with substantial delays. In 1994 it was 42% of firms that paid dividends on ordinary shares, announced in shareholder meetings between March and May of 1995. Because there was no liquid market for many of the shares in the sample, there are often no meaningful share prices available. Therefore this paper uses a

dummy variable on whether dividends were paid ('Div') instead of dividend yields.

As first pointed out by Modigliani and Miller (1963), payments of dividends would not matter in a perfect market setting. However, in an environment of asymmetric information payment of substantial dividends could indicate that management honours the right of shareholders with respect to income generated by the firm. In particular, as the majority of Russian firms face very large investment needs and at the same time rarely generate sufficient funds to meet them internally, dividend payments can serve two different functions: First, it could be that dividends are paid to signal that management is of the type that honours shareholder rights. After all, the costs of paying dividends is higher for management that otherwise would steal profits than for management that would otherwise reinvest profits¹⁹. However, payment of dividends is the only indicator of shareholder rights where the coefficient of correlation with the other indicators is, in general, no different from zero at the 10% significance level. This would imply that dividends do not act as a very strong signal of shareholder-friendliness. Second, it could be that management, which in general owns a substantial share package, wants to get money out of the firm for the sake of personal consumption without selling part of its share package. Indeed, it is plausible for agents in transition economies to increase present consumption relative to future consumption and it is also often the case that management is highly reluctant to limit its control by selling shares. While this seems more plausible, there is no direct evidence for this proposition.

Table 2
Correlation of Indicators of Shareholder Rights

	IAS	ADR	DISCLOSURE	DIV	LICENSE	TRANSFER
IAS	1.000	0.345 (0.000)	0.326 (0.000)	-0.001 (0.986)	0.233 (0.005)	0.301 (0.000)
ADR		1.000	0.557 (0.000)	0.122 (0.150)	0.274 (0.001)	0.488 (0.000)
DISCLOSURE			1.000	0.139 (0.101)	0.314 (0.000)	0.883 (0.000)

DIV	1.000	0.047 (0.579)	0.065 (0.443)
LICENSE		1.000	0.350 (0.000)
TRANSFER			1.000

p-values in brackets

The positive and significant correlations between the indicators that relate to control rights allow the construction of an index for shareholder-friendliness. This is a sensible procedure because I want as good a measure for ‘shareholder-friendliness’ as possible. Since all the listed indicators are associated with the underlying ‘shareholder-friendliness’, the index is a meaningful variable to analyse. The index is constructed by normalising the two survey measures to variables with mean 0 and standard deviation of 1. Then all five measures (excluding the dividend dummy) are added up.

3. WHICH FIRMS HONOUR SHAREHOLDER RIGHTS? A SIMPLE MODEL

It has frequently been noted that during transition management is often in control of the firms, even if this is not reflected in the ownership structure. Therefore it is important to analyse the incentives of management with respect to shareholder rights. The following simple model does this under the basic assumption that management has absolute control over the firm, irrespective of the size of its own stake in firm 'i', denoted by ' S_i '. This allows management to steal part of the profits with a present value of ' b_i ', which is a random variable, if no shareholder rights are introduced. The amount that can be stolen is a function of the size of the firm, as measured by employment ('e'). In general, larger firms are much more tightly observed and more often regulated by government institutions than small ones. The tax service, regulatory bodies, ministries or former ministries are much more likely to scrutinise large firms than small ones. This should make it harder for these firms to steal on a large scale (in particular, if we analyse stealing per head of the people that have the possibility to steal). Furthermore, the punishment if caught stealing is likely to be higher for the large firms because they are much more visible. It would therefore make sense to punish them severely to deter other firms from stealing. Therefore, the expected value of stealing should decrease with size. On the other hand, it can be argued that larger firms are in a more complex environment which increases the possibility to steal. Therefore, the empirical investigation should help to find the correct sign of the derivative of 'b' with respect to 'e'. The value of the existing assets if this stealing takes place is ' a_i '. Apart from the possibility to steal, management also gets private benefits from running the company, denoted by ' $c_i(e_i)$ '. They are a positive function of the size of the firm, as measured by employment. Once shareholder rights have been introduced, there is a chance that management loses control and therefore these private benefits. The likelihood of this happening is a random variable denoted by 'p', which depends negatively on the stake owned by management and

positively on the stake the largest outside owner owns, ‘ L_i ’. Once shareholder rights are introduced, it is impossible to steal²⁰. Furthermore, the firm has a new project it wants to fund, whose present value accruing to the old shareholder is a random variable denoted by ‘ n_i ’. It needs outside capital for this project. It is only possible to obtain this external finance if shareholder rights are introduced²¹. This implies that risk-neutral management chooses to introduce shareholder rights, if

$$E [S_i a_i + b_i(e_i) + c_i | O_i] \leq E [S_i (a_i + b_i(e_i)) + [1-p(S_i, L_i)] c_i(e_i) + S_i n_i | O_i], \quad (1)$$

where ‘ E ’ denotes the expected value, conditional on the information set of management of firm ‘ I ’, denoted by ‘ O_i ’. This simplifies to

$$E [b_i(e_i) | O_i] \leq E [(S_i n_i - p(S_i, L_i)c_i) / (1- S_i) | O_i] \quad (2)$$

It is straightforward to see how management’s choice is influenced by the different parameters. The partial derivative with respect to ‘ n_i ’ is positive: The larger the gains of the new investment, the higher is the likelihood of shareholder-friendly behaviour²². With respect to ‘ b_i ’ the partial derivative is negative. The more that can be stolen in a given firm, the more unlikely it is that management introduces shareholder rights. The same is true with respect to ‘ c_i ’. The larger the private benefits of control, the less willing is management to introduce shareholder rights. As regards employment, the effect is not clear. As pointed out above, the derivative of ‘ b_i ’ with respect to ‘ e_i ’ cannot be derived from theoretical considerations. And ‘ c_i ’ also depends on ‘ e_i ’²³. Lastly, with respect to ownership, the likelihood of shareholder-friendly behaviour in the above model increases with the share owned by management and decreases with the share owned by the largest outside shareholder. This is true for two reasons. First, the more management owns, the smaller is the perceived threat to its control.

Therefore management gains less from trying to discourage active participation of outside shareholders in shareholder meetings. Second, the more management owns, the smaller are the incentives to steal since it owns a larger part of the profits legally²⁴. Of course, this assumes that the different layers of management that own shares collude and act like one shareholder would. If they instead compete in stealing from the firm this effect is unlikely to be observed²⁵. The model relies on the assumption that management behaviour is completely unchecked. In reality, the freedom of management is likely to be restricted by two different sources.

First, outside private blockholders could potentially be able to exert some influence on management. Even though privatisation very often resulted in handing out large parts of the shares to insiders, there are nevertheless quite a number of outside blockholders in many Russian enterprises. These outsiders can be banks, investment funds and brokerages, financial-industrial groups, non-financial firms or foreign firms. If management has no sufficient incentives in the above model to introduce shareholder rights, these outsiders could either collude in stealing or press for shareholder rights. If they collude, a bargaining game is played on how to split the rents from stealing ‘ b_i ’. The bargaining power depends on the relative stakes of the two parties. If outsiders press for shareholder rights, they succeed with probability ‘ q ’, which depends positively on ‘ L_i ’ and negatively on ‘ S_i ’. Abstracting from the possibility of a change of management (that is, of redistributing ‘ c ’) the fallback option for management in case the bargaining breaks down is

$$E [a_i S_i + c_i(e_i) + (1-q) b_i (e_i) + q S_i (b_i (e_i) + n_i) | O_i] \quad (3)$$

The expected value of the fallback option of the outsider is

$$E [a_i L_i + q L_i (b_i (e_i) + n_i) | O_{oi}], \quad (4)$$

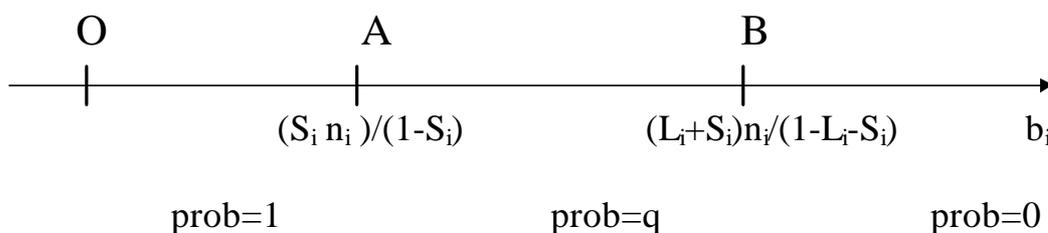
where ‘ O_{oi} ’ denotes the information set of the outsiders concerning firm ‘ i ’. Assuming that management and outsiders have the same information, the total amount the two parties can bargain over is

$$E [a_i (L_i+S_i) + b_i (e_i)+ c_i(e_i) | O_i] \tag{5}$$

Collusion is the preferred strategy whenever there is a surplus over the fallback strategy for the two parties. This is true as the Nash bargaining mechanism makes both players with positive bargaining power strictly better off than their fallback position. Therefore, the two parties will *not* collude if

$$E [b_i(e_i)| O_i] \leq E [(L_i+S_i) n_i / (1- L_i-S_i) | O_i] \tag{6}$$

In this case, shareholder rights will be introduced with probability ‘ q ’ (L_i, S_i). Taking account of equation (2) which describes when management has incentives to introduce shareholder rights by itself, there are three regions with varying likelihood of shareholder rights²⁶:



For firms with values of ‘ b ’ between ‘ O ’ and ‘ A ’, management introduces shareholder rights, just as in the case with 100% management control. Between points ‘ A ’ and ‘ B ’, shareholder rights are introduced with probability ‘ q ’ (L_i, S_i), that is if the outsider succeeds in pushing for shareholder rights. For values of ‘ b_i ’ above point B , no shareholder rights are introduced as the outside blockholder and management collude. In this variation of the set-up, the comparative statics are essentially the same as above. The only exception is the changes with respect to the share of the outside

blockholder, 'L_i'. Now the larger the share of the outsider, the more likely it is that shareholder rights are introduced. Between points 'A' and 'B' the likelihood rises as the outsider becomes stronger to push for these rights. And at the same time point 'B' shifts to the right, decreasing the area of collusion. This is true because as the benefit from taking advantage of the small outside shareholders decreases, the larger the combined share of management and the large outsider²⁷. This is the opposite of the case of 100% management control and an empirical investigation is necessary to see which of the two scenarios is more likely.

However, in general ownership might not be exogenous. Although this paper represents very much an initial look at the ownership structures as they emerged from the privatisation program, it is still possible that the size of the largest outside stake might be endogenous. In particular, concentration in outside ownership could act as a substitute for poor legal protection, as argued by La Porta *et al* (1996). If this was true, one would expect large shareholders to invest in firms that do not honour shareholder rights (to subsequently use their bargaining power to collude in stealing or to push for shareholder rights). Smaller shareholders, because they have little bargaining power, are more likely to pick firms where management is committed to honour shareholder rights. Furthermore, in the above model it is only the large shareholders, who have an incentive to increase their stake 'L', who are in a situation where no shareholder rights are honoured and where no collusion takes place. This is true as the value of their existing shares increases with 'q', which is a positive function of 'L'. Under this scenario the size of the small outside blockholding should be associated with relatively high levels of shareholders protection, just as in the case of fully management controlled firms²⁸.

Apart from outside blockholders, the state could play a role in controlling management. It is an important feature of large Russian enterprises that the state still holds substantial stakes in many of them, even after they have been 'privatised'. A World Bank survey carried out in the summer of 1994 found that only in 35% of 'privatised' Russian firms the state held no shares (Pistor and

Turkewitz, 1996). In 17% of firms the state ownership was between 0% and 10%, and in 19% of firms between 10% and 20%. In the context of this paper state holdings also include holdings by regions or state organisations. It has been asserted that the state does not in general use the ownership rights that are attached to the firm or is implicitly colluding with management (Frydman *et al*, 1996). However, this seems to be the case mainly in respect to participation in strategic decisions, where the last decades have taught the state that it has no comparative advantage in making these decisions. It is more likely that the state does use its voting rights to press for the implementation of shareholder rights. This can be expected because the state is planning to sell-off its remaining stakes in the near future and is therefore interested in higher share prices. This commitment makes it different to the type of private outside blockholder who invests into the company for the long run. Apart from these private incentives as an owner, the state also has an interest to promote better corporate governance to increase the likelihood of successful restructuring. For this to happen a mechanism to reallocate controlling rights over enterprises is necessary, one of which can be the share market. This possibility increases incentives for the state to push for shareholder-friendly behaviour. As a matter of fact, the activity of the FSC and the introduction of the laws cited above give some credibility to the hypothesis that the state recognises its interest in promoting shareholder rights. More specifically, the government passed a resolution in February 1995 under which it will not provide any help to companies which violate shareholder rights. While it is clear that enforcement of this legislation is difficult through ‘normal’ channels of the legal system, it seems possible that the directors on the board that represent the state are better positioned to influence management’s decisions in this respect. On the other hand, if the state has different objectives such as avoiding unemployment, it is unlikely that it would push for shareholder rights²⁹. This is true as outside shareholders are more likely to restructure the enterprises actively.

4. THE DATA

As opposed to the enterprise surveys carried out by the World Bank and by Blasi and Shleifer, this paper analyses data on enterprises collected by brokerages and financial information services and not information that is directly collected from the firms. Therefore there are only firms in the sample that are organised as open joint stock companies. Furthermore, the data set only comprises information on the largest Russian firms (by sales), as the interest of investors is naturally highest in these firms. This makes this study complementary to the ones mentioned above, which focus mainly on small and medium sized firms. Furthermore, the focus on large firms should give the study some macroeconomic relevance, as the firms in the sample represent a significant amount of the total industrial workforce (27%). Given that data is collected in a transition economy, there is an issue of the quality of the data. In particular, it is an open question as to what extent managers reveal information truthfully. It seems likely that differences in the quality of data between direct sampling and using information of brokerages are slight, as these institutions obtain their information by visiting the enterprise and interviewing management as well. Since brokerages are likely to have other sources of information on these firms as well, it could be the case that they find it easier to cross-check the data and improve its reliability. For example, information on the ownership structure of a firm can be cross-checked by observing its general shareholders meeting, which brokerages do to some extent. Furthermore, these brokerages have access to the products of financial information providers such as Skatepress and Dun and Bradstreet, who also interview companies and their management. Nevertheless, it is possible that some outside blockholdings are omitted in my data. This problem should be more important for relatively smallish stakes, as these shareholdings are not necessarily disclosed during the general meeting. Therefore, in the regression analysis I focus on the stake of the largest outside blockholder, where I believe that omissions should be negligible. The sample of this paper was constructed by merging data from different sources

into one dataset. I have obtained data from Brunswick Brokerage, Renaissance Capital and Troika Dialog. Therefore, it is possible that different series have different numbers of observations.

The sample contains 140 firms which overall employ 3.9 million employees. The mean employment is 25,300. The firms are concentrated in the following industries: communications, electricity, metallurgy, transport and oil and gaz. For a detailed breakdown by industry see Appendix B. The majority of firms are registered in Moscow, but almost every region is represented in the sample. Given that a firm whose production facilities are all in Siberia could choose to have its headquarters registered in Moscow, the predominance of Moscow firms does not imply that there is a regional bias in the sample³⁰.

Ownership data is given as of the end of January 1996. The average number of outside blockholder is 1.7, the median is 1.0. Blockholders are defined as institutions or individuals that hold more than 5% of the shares. These blockholders hold together on average 29.7% of the shares, with a median of 27.6. The largest of the blockholders holds on average 23.0%, the median being 20%. In 17% of firms, no outside blockholder is reported. These values are similar to the ones found by the Blasi and Shleifer survey (BSS) of medium sized firms (see Table 3). They report for the end of 1995 an average stake of outsiders of 31.2%. However, the composition of outside blockholders is very different in the two samples. The following numbers report the average of the largest owner of a given type in a given firm³¹: The outside owner with the largest average stake were holding-companies and officially registered financial-industrial groups (FIGs) with an average of 11.4%. The second largest outside stake is held by non-financial firms, 6.7% on average. Investment funds (including brokerages) have the same average stake as banks: 3.5%. Lastly, foreign financial firm has an average stake of 2.1%³². The distribution is highly uneven, though. The median for all these ownership classes is 0%, that is, in more than 50% of firms the given institution does not own any shares. The ownership structure by industry is given in Appendix C. Compared to BSS, where holding companies or FIGs own on average 4.9%, this sample

has a much higher average ownership by this type of firm and a much lower ownership of Russian commercial firms.

Apart from outside owners there are also pronounced differences in the stake the state still holds in these firms. In my sample, the average stake is 13%, as opposed to 9% in BSS. In both cases the median is 0, pointing once more to the concentration of the stakes. These numbers also could imply that the state is more actively involved in the management of the larger firms.

Table 3
Ownership of Russian Firms

	This sample	BSS
Sample size	140	185
Date	Jan-96	Q4-95
Mean Employment	25,300	2,444
Mean number of outside blockholder (>5%)	1.7	NA
Mean holding of outside blockholders	29.7	31.0
Mean holding of largest blockholder	23.0	NA
of which		
Holding or FIG	11.4	2.6
Non-financial firms	6.7	14.6
Investment funds	3.5	4.9
Banks	3.5	2.0
Foreign financial firm	2.1	0.0
State	13.0	9.0

Some of the variables in the simple model above are not directly observable. But some plausible proxies exist. As a proxy for benefits from raising capital, ni , industry dummies are introduced. In particular, a dummy for the communications industry ('Comm'), for the electricity industry ('Electricity'), for the oil and gaz industry ('Oil and Gaz'), for the metal industry ('Metal') and for transportation ('Transport') is used. A list of all variables used in this paper is attached as Appendix A. Another proxy for investment needs is the percentage of fixed assets in a firms balance sheet. While it is clear that this number, which is taken from the firms Russian financial accounts, cannot be compared to the Western equivalent, it is still possible that there is some information in the cross-section across Russian firms. Assuming that the physical assets of all firms have to be replaced to a similar extent, the percentage of fixed assets in the balance sheet can proxy for this investment (Table 4).

Table 4
Average Percentage of Fixed Assets in Balance Sheet

Comm	77.08 (10.48)
Transport	67.83 (20.56)
Electricity	57.85 (15.81)
Oil and Gaz	56.99 (20.15)
Metal	47.41 (15.26)

Standard deviation in brackets

These correlations would indicate that investment needs are particularly high in the communications industry, high in the transportation industry and rather low in the metals industry³³. The actual value for the fixed assets is not used in the regressions as it is available for only 100 firms and as they are presumably very noisy³⁴.

With respect to the decision to pay dividends, the profits of the firm are also clearly relevant. In 1994 dividends were declared by 43% of firms in the sample, but usually dividends were rather small. The regression that tries to explain them uses the return (Russian gross profits) over sales ('ROS'), as well for the year 1994. ROS is available for 98 firms. Again, this measure is used in the hope that there is some information in the cross-section over Russian firms, even if that number cannot be compared to its Western equivalent. The average return on sales for 1994 was 18%. As data on the accounts for 1995 was available for far fewer companies, the data for 1994 was used. Furthermore, using the year 1994 also gets rid of the problem that in 1995 some firms had already been using IAS, which could bias this measure.

5. TESTING THE HYPOTHESES

In a first step it is necessary to check the assumption that better behaviour towards shareholders is likely to be reflected in a higher valuation of the firm (which should increase by b_i). Analysing first the p/e ratio, there should be some effect regardless of the timing of the introduction of shareholder rights³⁵. And, indeed, 'Index' has a positive coefficient which is significant with a p-value of 0.087³⁶. This demonstrates that the shareholder-friendliness of management does affect the valuation of the firms³⁷. If the index constructed above rises by 1 unit, the P/E-ratio rises on average by 2.7. 'e' and 'Div' were dropped in this regression, as they had no significance. The industry-dummy 'Transport' is significant at the 10% level. This would indicate that the market expects profits to grow most quickly in the transportation industry. In the electricity industry the opposite seems to be the case. The overall regression has an adjusted R squared of 0.32 and is significant at the 1% level³⁸.

Secondly, the return of the shares during 1995 (capital gain adjusted for dividend payments and share-splits) is regressed on indicators of shareholders rights as well as on industry dummies and size. Dummies have been introduced to capture differences in the competitive environment across industries. Size was put into the regression to control for potentially differing restructuring needs according to firm size. The coefficient of the index of shareholder rights has the opposite sign that was expected, but is not significant. This is not too surprising, as one would only expect these firms to outperform the market if the changes had *unexpectedly* been introduced during 1995. Whenever these changes happened or had been expected before 1995, it is clear that no reaction can be observed. Industry dummies are also insignificant. This is interesting as it indicates that the industry dummies do not capture differences in the competitive environment across industries very well. It seems much more to depend on the firm level than on the industry level whether a firm is successful as measured by the share price performance. Furthermore, the insignificance of size implies that restructuring needs do not systematically differ by firm size. Whether

a dividend is paid affects the return significantly at the 1% level. This is consistent with the observation that share prices do not always fall in line with the dividend payment on the ex-dividend day³⁹. However, the explanation for this phenomenon is partly that pledged dividends are frequently paid with substantial delays and the ex-dividend date is not always known. This would tend to overstate the return of firms that pay dividends (since the calculation assumes that dividends are actually paid fully and immediately). Furthermore, as will be more formally shown below, dividend payments are, *ceteris paribus*, more likely the larger the firms' (Russian accounting) profits. Even though these profits can not be compared to their Western equivalent, they seem to be reflected in the share price performance. If the profits are put into the regression, 'Div' becomes insignificant. Therefore, it cannot be concluded that the payments of dividends act as a signal to shareholders that management is of a shareholder-friendly type, at least not a signal that conveys more information than the profit figure. The regression is nevertheless significant at the 1% level and its adjusted R2 is 0.17.

Table 5
Return and P/E Regressions

	OLS with robust standard errors	OLS with robust standard errors	OLS with robust standard errors
Dependent variables	P/E	Return	Return
C	0.587 (0.306)	16.784 (0.558)	49.616 (1.133)
Index	2.577* (1.743)	-7.784 (-1.528)	-7.489 (-1.194)
Div	-	104.244*** (3.843)	43.775 (1.273)
ROS	-	-	0.775 (0.580)
Comm	-3.401 (-1.106)	-37.995 (-1.220)	-101.619* (-1.839)
Electricity	-9.048* (-1.637)	-36.728 (-0.692)	-38.698 (-0.657)
Metal	1.295 (0.622)	-58.293 (-1.320)	-86.961 (-1.625)
Oil and Gaz	4.982 (1.081)	-53.333 (-1.538)	-97.204** (-2.267)
Transport	127.026* (1.741)	-38.364 (-0.983)	-49.004 (-0.842)
e	-	0.001 (0.846)	0.001 (1.040)
e ²	-	-2.32E-09 (-1.341)	-2.99E-09 (-1.298)
N	66	66	47
R-squared	0.3872	0.2877	0.2824
adj. R-squared	0.3227	0.1733	0.0831
F-statistic	3.41	3.55	2.82
Prob(F-statistic)	0.0041	0.0015	0.0109

t values are given in brackets. ‘*’ denotes significance at the 10% level, ‘**’ at the 5% level and ‘***’ at the 1% level.

Given that shareholder-friendliness is reflected in the valuation of a firm, is it also the case that firms who honour shareholder rights make use of this fact to fund their investment needs? Table 6 shows that the correlation of the number of share-issues a firm has undertaken and the indicators of behaviour towards shareholder are

all positively correlated. This implies that management indeed treats shareholders well in order to raise new capital. However, it has to be borne in mind that in many of these share-issues no new capital has been raised. In general, most of the new shares were just allocated to the old shareholders when the capital of a firm was revalued. In this case, the firm does not receive any new capital. However, since these revaluations are likely to have happened the same amount of times for all the firms, a higher than average number of issues is likely to reflect genuine share issues that did raise new capital. This effect is picked up by the correlations⁴⁰.

Table 6
Correlation Between Share Issues and Shareholder Rights

License	0.202 (0.019)
Transfer	0.141 (0.105)
IAS	0.177 (0.040)
Disclose	0.277 (0.001)
ADR	0.294 (0.001)
Dividend	0.269 (0.002)

p-values in brackets

Having thus tested one of the assumptions of the above model, regressions are run to explain which firms are more shareholder-friendly. Concerning ‘Index’, OLS regressions were run and for ‘Div’ probit regressions. First, only variables that were definitely exogenous to the problem were used: employment (‘e’), industry dummies and share of the state (‘State’). In a second step the size of the ownership of the largest outsider (‘Largest’) was added. These regressions have to be interpreted with care as it is not entirely clear whether ‘Largest’ is truly exogenous. However, there is no obvious instrument available and it turns out that the sign of the coefficient is the opposite of what one would expect under the hypothesis of

endogeneity. As White tests indicated that the hypothesis of non-heteroskedasticity had to be rejected at the 5% level for these regressions, the OLS as well as the probit regressions were run with robust variance-covariance matrix.

The 'Index' -regression has an adjusted R² of 0.28 and is significant at the 1% level. Employment 'e' is positive and significant at the 1% level and its square is negative and significant. The point estimates imply that for firms with employment of less than roughly 534,000, shareholder-friendliness increases with employment, but at a decreasing rate. As the largest firm in the sample has 360,000 employees, this is true for all firms in the sample. Formally, I cannot distinguish whether this is due to fixed costs of entering the capital market or due to the higher ease of stealing in small firms. However, I find the latter argument more plausible, as even the smaller firms in my sample are likely to have investment needs that are large enough to make the fixed costs of equity issues negligible. Then the derivative of b_i with respect to e_i would be positive. There is no evidence that stealing in larger firms is facilitated due to the more complex environment. Furthermore, if private benefits to management of running the firm, c_i , are positively correlated with 'e' they are empirically not the most relevant aspect.

The variable 'State' has a positive coefficient, which is significant at the 10% level. The hypothesis that the state hinders the introduction of shareholder rights because it wants to avoid restructuring for exogenous reasons is clearly not borne out by the data. The findings can be interpreted as evidence for the hypothesis that the state does use its voting rights to cause management to honour shareholder rights⁴¹. This is also consistent with survey data for the Ukraine, reported by Daniel Kauffmann (1996). There it is shown that state enterprises under-report less of their sales than privatised or new private firms. This is presumably true as the state in its role as shareholder observes the firm more tightly and might press for truthful recording⁴². An alternative hypothesis would be that management feels less threatened by outside blockholders who might aim for control of the firm the more shares the state holds. After all, the larger the state-ownership, the smaller the likelihood of

a hostile take-over. However, given that management is likely to anticipate the sell-off of the state's stakes, this line of reasoning would also imply that management believes that the privatisation process is likely to be discontinued or will result in even more inside ownership. This does not seem very plausible⁴³.

Adding the variable 'Largest' and its squared values to the regression leaves all coefficients with the same sign as previously. With respect to 'Largest' the underlying specification seems to be quadratic. For small outsider stakes, the coefficient is positive (and significant at the 10% level), but the coefficient of the squared 'Largest' is negative and significant at the 5% level. The estimated coefficients imply that for outside stakes larger than 42%, shareholder-friendliness starts to decrease. As 'Largest' is in general smaller than 42%, the basic effect of this variable is positive, if at a decreasing rate⁴⁴. This would lend some credibility to the hypothesis that the outside shareholders bargain with management. As their bargaining power increases, they tend to be more successful in pushing for shareholder rights. They are also less likely to collude with management, as they can benefit less from stealing. The data does not suggest that management has unlimited control in the absence of shareholder rights, as for this case the above model would imply a negative sign for 'Largest'. The positive coefficient would also make it harder to argue that 'Largest' is endogenous.

Of the industry dummies, only 'Metal' is significant (at the 5% level) and has a negative coefficient. The communications industry has the largest (and positive) coefficient of all industries, but it is insignificant at the 10% level. If 'Largest' is included, the Electricity industry also becomes significant and positive. This is roughly in line with investment needs, as proxied by the ratio of fixed assets in the balance sheet. According to this measure, it is the communications industry with the largest, and the metals industry with the lowest, investment needs. Therefore there is some weak evidence that the industry dummies can act as a proxy for returns from future investment, η_i . This is in line with the observation that the communications industry has presumably the highest increase in demand for its services of all the industries for which a dummy has

been introduced. It is noteworthy that the investment needs we talk about are the needs that would potentially be fulfilled by share-issues. In the case of oil-firms, for example, it could be the case that new projects are mainly implemented by joint ventures with foreign firms, who would raise a large part of the required finance.

Table 7
Index-Regressions

Dependent Variable is Index	OLS with robust standard errors	OLS with robust standard errors
C	-0.608 (-1.630)	-0.799* (-1.735)
State	0.026* (1.688)	0.022 (1.594)
Comm	1.785 (1.138)	1.903 (1.182)
Electricity	1.162 (1.541)	1.725** (2.065)
Metal	-0.659** (-2.299)	-0.561* (-1.899)
Oil and Gaz	-0.241 (-0.475)	-0.012 (-0.024)
Transport	-0.301 (-0.667)	-0.246 (-0.572)
e	4.29E-05*** (3.103)	4.39E-05*** (3.226)
e^2	-8.03E-11** (-2.092)	-8.27E-11** (-2.166)
Largest	-	0.038* (1.790)
Largest^2	-	-0.001** (-2.342)
N	140	140
R squared	0.3237	0.3427
adjusted R squared	0.2824	0.2917
F-statistic	2.87	2.41
Prob(F-statistic)	0.0057	0.0117

T-statistics are given in brackets. ‘*’ denotes significance at the 10% level, ‘**’ at the 5% level and ‘***’ at the 1% level.

Lastly, the decision to announce dividends on ordinary shares for the year of 1994 is analysed (Table 8). In these regressions the additional variable 'ROS', the return over sales in the year 1994, is introduced. As could be expected, its coefficient is positive and significant at the 1% level. Even though the Russian accounting data seems ill-suited to compare the firms to Western equivalents, there seems to be some information in this data that is helpful to analyse dividend decisions of Russian managers. 'e' is, once more, significant at the 1% level and positive. If the expected value of stealing is lower in large firms, manager might be more willing to pay out dividends.

The state does not press for dividend payments. It seems mainly concerned to put the firm in a position where the control rights of shareholders can be guaranteed⁴⁵. For 'Largest', the coefficients have the opposite sign of the ones which explain 'Index', one of them is significant at the 10% level. This also implies that the incentives for the largest outside blockholders with respect to dividends are different from the ones with respect to control rights. Dividend payments are also not directly in line with investment needs. While the electricity firms all announced dividends, firms in the communications industry were less likely to declare dividends on ordinary shares. These findings seem to suggest that dividend payments are not used to signal to investors that management honours shareholder rights. This conclusion is supported by the fact that the dummy for dividend payments is not positively correlated with other measures of shareholder rights. Lastly, in the return regressions dividends are not significant if it is controlled for profits. One hypothesis concerning dividend payments would be the following: If management can determine the ex-dividend date ex-post they could use this decision to channel funds to certain shareholders that are close to management. Therefore paying dividends could not be used to signal that management is of a shareholder-friendly type and large shareholders would then not push for these payments.

Table 8
DIV Regressions

Dependent Variable is DIV	PROBIT with robust standard errors	PROBIT with robust standard errors
C	-1.563** (-3.113)	-1.570** (-2.210)
ROS	0.053*** (3.633)	0.056*** (3.457)
State	-0.011 (-0.977)	-0.008 (-0.651)
Comm	-0.676 (-1.015)	-0.871 (-1.223)
Electricity	+++	+++
Metal	-0.033 (-0.083)	-0.161 (-0.384)
Oil and Gaz	0.272 (0.509)	-0.016 (-0.028)
Transport	1.918*** (2.644)	2.034*** (2.639)
e	1.51E-05*** (2.584)	1.89E-05*** (2.721)
Largest	-	-0.037 (-1.069)
Largest^2	-	0.001* (1.686)
N	86	86
Log likelihood	-43.505741	-41.426515
Likelihood ratio	0.2462	0.2822
chi2	25.96	28.82
Prob(chi2)	0.0011	0.0013

T-statistics are given in brackets. ‘*’ denotes significance at the 10% level, ‘**’ at the 5% level and ‘***’ at the 1% level.

+++ : The observations of the electricity sector were dropped since all the 11 firms declared dividends. Whether a firm is in the electricity sector is therefore a perfect predictor of whether dividends are declared.

6. SOME CONCLUSIONS

To the extent privatisation resulted in strong *de facto* insider control, which is not necessarily reflected in formal ownership, management has incentives different from those of formal owners. While in principle the resulting problems can be mitigated by introducing laws on shareholder (and creditor) rights, law enforcement is often difficult during the development of the capital markets. This management behaviour can be explained by the fact that the main objective of management is to keep control of the firm and to consolidate their *de facto* control. This is likely to lead to inefficient decisions concerning the restructuring of the firm, in particular, if restructuring requires outside (human and physical) capital. However, the problems can be mitigated in two different ways.

First, self interest might cause management to start to honour shareholder rights. If the potential returns to investment that accrue to management in its role as shareholder outweigh the utility-loss of reduced control over the firm, management might be more willing to honour shareholder rights. The significance of employment, which I take as a proxy for the expected value of stealing, would tend to support this hypothesis. Furthermore, weak evidence that investment needs as proxied by industry dummies matter also gives some evidence that this effect plays a role.

Second, outside pressures might be strong enough to force management to introduce shareholder rights. The paper presents some evidence that the largest outside investor has some bargaining power as well that can be used to introduce shareholder rights. This effect becomes weaker for very large shareholders, though. Furthermore, there is some evidence that the state might be able to use its remaining shares in the firms to put pressure on management to introduce shareholder rights. Even if the state is passive in the management of the company, it has a strong incentive to increase the valuation of the firms since it is committed to sell its shares off in the foreseeable future. More broadly speaking this implies that in the context of weak law enforcement, limited state involvement in the firms could keep management in check.

ENDNOTES

1. While the share issue had been authorised by shareholders at the annual shareholders meeting, the price at which the sale took place might constitute a violation of the law on joint stock companies. This law lays out that new issues have to be sold at or above market prices. The Federal Securities Commission (FSC), the regulatory body for the Russian capital markets with ministerial rank, is at present examining this case.
2. These shares are not necessarily very liquid. Only for about 50 firms is there reliable share price information available. Shares in the other 80 firms are highly illiquid and only very few trades occur.
3. My data does not distinguish between shares held by regional administrations and by the federal one.
4. Even if the letter of the law is honoured, inexperienced courts combined with ambiguous legislation might lead to the possibility of more subtle violations of the spirit of the laws.
5. For one of the earliest manifestations of this idea see, for example, Grossman and Hart (1980).
6. The privatisation process in Russia allowed for three different options to privatise a firm which differ by how much (and what type) of the shares are allocated to insiders.
7. The discount has also been related to a risk that preference shares are going to be swapped into ordinaries at unfavourable rates. However, holder of preference shares have the right to vote on these issues. As a swap would necessitate a change in the corporate charter which requires a 75% majority, this risk is rather small given that preference shares amount to 25% of charter capital. This risk is therefore mainly relevant, if one believes that management is in effect not bound by the corporate charter.

8. See, for example, Levy (1982) or Zingales (1995).
9. For example, in 1994 the director of the Krasnoyarsk Aluminium Factory cancelled out a 20% shareholding of a British metal firm. However, this shareholding was subsequently reinstated due to political pressure on management.
10. Since another question in the survey related more directly to the liquidity of the share, this question is likely to pick up mainly legal aspects and differences in transaction costs of re-registering shares. These, in turn, can be directly controlled by management.
11. Each firm received points depending on their rank (ranging from 30 to 10, in steps of 5) implying that the final rating would be between 0 and 9,240. In response to this question, 222 companies were mentioned.
12. In addition, the law on the securities market, which came into effect in April 1996, details disclosure requirements for the case of the issue of new securities.
13. See Financial Times, 21 February 1997.
14. To be precise the variable measures whether accounts have been done by a Western accounting firms. While it does at times happen that these firms are asked to produce Russian style accounts, this seems to be quite rare. Furthermore, even if this is the case it still signals that management is comparatively shareholder-friendly, as accounts checked by a Western accounting firm with a reputation to lose is likely to be more reliable than the one provided by a Russian firm.
15. See Moscow Times, 18 September 1996. As this policy has just been announced it is unlikely to have affected the choice of accounting rules in the sample.

16. In an interview in the Moscow Times (16 November 1996), management of Surgutneftegaz stated that ‘competent analysts should have guessed that we were going to do this (the dilution) before the ADR issue (which is planned for later this year) because later it would be more difficult and more trouble’.

17. Level 2 ADRs are listed at an exchange, whereas level 1 ADRs are traded over the counter. Level 2 ADRs also allow to raise new capital for the firm only to the extent that the firm’s treasury holds the underlying shares.

18. In this context it is important to focus on dividends paid on ordinary shares and not on preference shares. This is true as during the privatisation process preference shares were only issued to employees, not to any outsiders. Subsequent trading in these shares was very limited as workers were obliged to keep these shares for three years after privatisation. Therefore dividends on preference shares mainly reflect payments to insiders and do not indicate good behaviour with respect to outside shareholders.

19. Formally, a dividend signalling model along the lines of Ross (1977) or Bhattacharya (1979) could be constructed to fit this case.

20. In this context the introduction of shareholder rights is assumed to be irreversible as a reversal would require a 75% majority in a general shareholder meeting.

21. In the context of the examination of shareholder rights, it would be natural to interpret the outside finance as raised by equity issues. However, bond issues are possible as well. To some extent the argument above can be applied to them as well. After all, firms that do not steal presumably find it easier to raise finance by bonds as well. In any case, there are at present no markets for corporate debt, but there is a reasonably liquid one for equities. This would facilitate equity issues as compared to debt issues. Apart from

tradable debt, there is the possibility to obtain loans. However, up to the present time there have not been many significant long-term loans, presumably partly due to the inflationary environment which would tend to favour equity as the cheaper indexation mechanism.

22. Akamatsu (1995) reports an example of this mechanism at work. Alfa Capital, who had bought 25% of Bolshevik Biscuit Company in December 1992, was not permitted in the shareholders' meeting. Subsequently Alfa Capital applied to a court, but without success. Finally, management allowed Alfa Capital into the meeting after it had promised to raise money to modernise the Bolshevik plant.

23. Another argument which would result in the same sign for 'E' are fixed costs to access capital markets. These fixed costs could deter smaller firms from aiming to tap these markets, which would reduce their incentives to implement shareholder-friendly policies. However, the fact that the sample only includes firms that are relatively large makes this argument rather unconvincing.

24. In a sample of Klepach *et al* (1996) the firms controlled by management are more likely to implement an 'active survival' strategy than employee-, state- or outsider-controlled firms. To the extent that this strategy comprises management trying to raise new funds, this finding supports the notion that the more management owns, the more likely is it that shareholder rights are introduced.

25. The very simple model above is static and cannot explain why a firm would switch from shareholder-unfriendly to shareholder-friendly behaviour. The principal mechanism I would like to suggest is that management buys up shares and an increase in S_i would then lead to a switch in behaviour. However, as I have no data on ownership over time, this will be left for subsequent research.

26. Again, this abstracts from threats to changes in private rents *c.* Furthermore, liquidity considerations are disregarded in this set-up.

27. This is a similar prediction as the one made by Shleifer and Vishny (1986) who argue that cumulating shares reduces the free rider problem of monitoring management and therefore can make management more likely to maximise shareholders' wealth.

28. If shareholder-unfriendly management could prevent shareholders from increasing their stakes, this could lead to the opposite bias. However, in reality it seems to be the case that management can, in general, not prevent share transactions among outsiders, but instead might choose not to disclose information etc.

29. See, for example, Shleifer and Vishny (1994). The authors show that public enterprises can be encouraged by politicians subject to pressure from interest groups, such as labour unions, to employ too many people.

30. To some extent it can even be argued that it is a sign of shareholder-friendly behaviour to register a firm in Moscow, as it may facilitate the attendance of shareholders at the general meeting. Therefore it is not advisable to control for the region the firm is registered in when running the regressions that are supposed to explain whether shareholder rights are honoured.

31. This means that if two investment funds have a block in a given company, the average includes only the block held by the larger of the two.

32. It should be noted that January 1996 was a point where foreign involvement in the Russian equity market was at its lowest point this year. Therefore one would expect much higher values for foreign ownership in late 1996.

33. It is indeed plausible that the investment needs in the communications industry are particularly high as demand for communications services multiplied with the change of the economic system in Russia. It is also worth noting that the first (and to date

only) Russian firm to issue a level 3 ADR was the telecom provider Vimplecom.

34. Including the variable into the subsequent regressions does not improve the fit.

35. Of course, if markets would expect that the other firms were about to honour shareholder rights this would be reflected in the market valuation and the variables in the regression should be insignificant.

36. Nash and Willer (1995) use a different measure for the valuation of some firms in the oil-industry and find that the variable 'Transfer' did help to explain differences in valuation.

37. It could also be argued that high p/e-ratios are the reason for honouring shareholder rights. If high p/e ratios proxied for high investment needs, this could be possible. While this would make it impossible to talk about causation in the above regression, it would be entirely consistent with the above model.

38. Depending on the assumption of how stealing develops over time one could also construct models where the p/e ratio should be negatively associated with the index (i.e. if stealing is likely to stop in the future). The positive coefficient above is due to two effects: First, managers can even steal announced profits (according to Russian accounting some payments are made out of profits, e.g. payments for social matters). Therefore, this money can be stolen. Second, when pre-stealing profits pick up after the transition period managers can steal more in relative terms (as well as in absolute terms). This would tend to depress the p/e ratio of these firms even under the assumption that the stealing is already reflected in the announced profit.

39. As noted in a Troika Dialog research note on the Russian equity market.

40. One of the most publicised share issues had been carried out by the Red October Chocolate Factory in 1995.

41. As a matter of fact, a presidential decree of 1 July 1996 explicitly states the following: “The capitalization of Russian companies should be increased in the following ways: Implementation of measures to increase the liquidity of the market, mainly by developing a system of protections for investor rights, including...reducing the costs and risks of the system of securities circulation and servicing, and providing for greater information transparency of the market”.

42. This finding is only at the first glance in some contrast to Earle *et al* (1996) who find no significant differences in restructuring behaviour by ownership. However, the measures of restructuring analysed by Earle *et al* take much more time to implement than changing the behaviour towards shareholders.

43. Furthermore, if the state was believed to hold onto its shares, there would be less incentives to behave in a shareholder-friendly way. This is true as the Law on the joint stock company states that equity issues in firms where the state holds more than 25% can only happen, if the share of the state is not diluted. This would tend to make equity issues less profitable.

44. Only in 14% of cases is the stake of the largest outside holder larger than 42%. The negative effect in the case of the very large outside holdings could be due to the fact that management, together with the largest outside blockholder, own so many shares that it is impossible to commit not to expropriate minority interests. This might be the case if together they own more than 75% and therefore can change the company charter at their discretion. If there are some arbitrarily small costs of introducing shareholder rights, these firms are then not going to do it.

45. As a matter of fact, the correlation is even negative. This squares well with the argument that enterprise managers see dividends on the state's stake like an additional tax and are therefore more unlikely to pay dividends.

APPENDIX A
List of Variables

ADR	Dummy whether an ADR, GDR or RDC has been issued
Comm	Dummy for the communications industry
Disclosure	Survey measure concerning the openness of the firm with respect to information
Div	Dummy variable whether dividends had been announced for 1994
e	Employment
e ²	'e' squared
Electricity	Dummy for the electricity industry
Employee	Combined shareholding of management and employees
IAS	Dummy variable whether an international accounting firm has been hired
Largest	Amount of shares the largest outside blockholder holds
Largest ²	'Largest' squared
License	Dummy whether a firm uses a licensed share registry
Metal	Dummy for metal industry
Oil and Gaz	Dummy for oil and gaz and chemical industry
ROS	Gross profits over sales for 1994
Transport	Dummy for the transportation industry
Transfer	Survey measure concerning the ease of transfer of ownership
State	Amount of shares the state holds

APPENDIX B
Shareholder Rights by Industry

	% of firms in industry	in the industry with			ADR & IAS	ADR & LR	IAS & LR	ADR & IAS & LR	Index
		ADR	IAS	Licensed Registrar (LR)					
Communication	6.4	33.3	33.3	22.2	33.3	22.2	22.2	22.2	2.331
Electricity	9.3	23.1	15.4	38.5	15.4	23.1	15.4	15.4	1.588
Metal	29.3	2.4	9.8	4.9	0.0	0.0	0.0	0.0	-0.307
Oil and Gaz	23.6	12.1	45.5	27.3	12.1	6.1	15.2	6.1	1.009
Transport	8.5	8.3	25.0	8.3	0.0	0.0	8.3	0.0	0.112
Other	22.9	6.4	21.8	15.3	2.9	0.0	2.9	0.0	0.277
Sum	100.0	10.0	24.3	17.1	7.1	5.0	7.8	4.3	0.518

APPENDIX C
Ownership by Industry

	Mean number of outside block- holders	Mean holding of			Non- fin. firms	Invest- ment fonds	Banks	Frgn fin. firm	State
		outside inves- tors	largest outsider	Holding or FIG					
Comm	1.6	31.8	27.7	22.1	2.2	0.8	0.6	4.5	25.0
Electricity	1.5	48.4	44.3	43.6	2.1	0.0	0.0	1.7	5.5
Metal	1.6	26.3	18.1	1.0	10.5	4.6	5.7	2.0	8.9
Oil and Gaz	1.5	31.2	27.7	20.6	1.7	1.2	4.4	2.2	16.9
Transport	1.5	19.3	12.7	0.0	6.6	4.5	2.4	3.1	25.7
Other	2.2	28.1	18.3	3.4	10.2	6.3	2.4	1.2	9.2
Sum	1.7	29.7	23.0	11.4	6.7	3.5	3.5	2.1	13

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ENDNOTES

¹ While the share issue had been authorised by shareholders at the annual shareholders meeting, the price at which the sale took place might constitute a violation of the law on joint stock companies. This law lays out that new issues have to be sold at or above market prices. The Federal Securities Commission (FSC), the regulatory body for the Russian capital markets with ministerial rank, is at present examining this case.

² These shares are not necessarily very liquid. Only for about 50 firms there is reliable share price information available. Shares in the other 80 firms are highly illiquid and only very few trades occur.

³ My data does not distinguish between shares held by regional administrations and by the federal one.

⁴ Even if the letter of the law is honoured, inexperienced courts combined with ambiguous legislation might lead to the possibility of more subtle violations of the spirit of the laws.

⁵ For one of the earliest manifestations of this idea see, for example, Grossman and Hart (1980).

⁶ The privatisation process in Russia allowed for 3 different options to privatise a firm which differ by how much (and what type) of the shares are allocated to insiders.

⁷ The discount has also been related to a risk that preference shares are going to be swapped into ordinaries at unfavourable rates. However, holder of preference shares have the right to vote on these issues. As a swap would necessitate a change in the corporate charter which requires a 75% majority, this risk is rather small given that preference shares amount to 25% of charter capital. This risk is therefore mainly relevant, if one believes that management is in effect not bound by the corporate charter.

⁸ See, for example, Levy (1982) or Zingales (1995).

⁹ For example, in 1994 the director of the Krasnoyarsk Aluminium Factory cancelled out a 20% shareholding of a British metal firm. However, this shareholding was subsequently reinstated due to political pressure on management.

¹⁰ Since another question in the survey related more directly to the liquidity of the share, this question is likely to pick up mainly legal aspects and differences in transaction costs of re-registering shares. These, in turn, can be directly controlled by management.

¹¹ Each firm received points depending on their rank (ranging from 30 to 10, in steps of 5) implying that the final rating would be between 0 and 9,240. In response to this question, 222 companies were mentioned.

¹² In addition, the law on the securities market, which came into effect in April 1996, details disclosure requirements for the case of the issue of new securities.

¹³ See Financial Times, of 21.2.1997

¹⁴ To be precise the variable measures whether accounts have been done by a Western accounting firms. While it does at times happen, that these firms are asked to produce Russian style accounts, this seems to be quite rare. Furthermore, even if this is the case, it still signals that management is comparatively shareholder-friendly, as accounts checked by a Western accounting firm with a reputation too lose is likely to be more reliable than the one provided by a Russian firm.

¹⁵ See Moscow Times, September 18, 1996. As this policy has just been announced it is unlikely to have affected the choice of accounting rules in the sample.

¹⁶ In an interview in the Moscow Times (16.11.96), management of Surgutneftegaz stated that ‘competent analysts should have guessed that we were going to do this (the dilution) before the ADR issue (which is planned for later this year) because later it would be more difficult and more trouble’.

¹⁷ Level 2 ADRs are listed at an exchange, whereas level 1 ADRs are traded over the counter. Level 2 ADRs also allow to raise new capital for the firm only to the extent that the firm’s treasury holds the underlying shares.

¹⁸ In this context, it is important to focus on dividends paid on ordinary shares and not on preference shares. This is true as during the privatisation process preference shares were only issued to employees, not to any outsiders. Subsequent trading in these shares was very limited as workers were obliged to keep these shares for three years after privatisation. Therefore, dividends on preference shares mainly reflect payments to insiders and do not indicate good behaviour with respect to outside shareholders.

¹⁹ Formally, a dividend signalling model along the lines of Ross (1977) or Bhattacharya (1979) could be constructed to fit this case.

²⁰ In this context the introduction of shareholder rights is assumed to be irreversible as a reversal would require a 75% majority in a general shareholder meeting.

²¹ In the context of the examination of shareholder rights, it would be natural to interpret the outside finance as raised by equity issues. However, bond issues are possible as well. To some extent the argument above can be applied to them as well. After all, firms

that do not steal find it presumably easier to raise finance by bonds as well. In any case, there are at present no markets for corporate debt, but there is a reasonably liquid one for equities. This would facilitate equity issues as compared to debt issues. Apart from tradable debt, there is the possibility to obtain loans. However, up to the present time, there have not been many significant long-term loans, presumably partly due to the inflationary environment, which would tend to favour equity as the cheaper indexation mechanism.

²² Akamatsu (1995) reports an example of this mechanism at work. Alfa Capital, who had bought 25% of Bolshevik Biscuit Company in December 1992, was not permitted in the shareholder's meeting. Subsequently Alfa Capital applied to a court, but without success. Finally, management allowed Alfa Capital into the meeting after it had promised to raise money to modernise the Bolshevik plant.

²³ Another argument which would result in the same sign for 'E' are fixed costs to access capital markets. These fixed costs could deter smaller firms from aiming to tap these markets, which would reduce their incentives to implement shareholder-friendly policies. However, the fact that the sample only includes firms that are relatively large, makes this argument rather unconvincing.

²⁴ In a sample of Klepach *et al* (1996) the firms controlled by management are more likely to implement an 'active survival' strategy than employee-, state- or outsider-controlled firms. To the extent that this strategy comprises management trying to raise new funds, this finding supports the notion that the more management owns, the more likely is it that shareholder rights are introduced.

²⁵ The very simple model above is static and can not explain why a firm would switch from shareholder-unfriendly to shareholder-friendly behaviour. The principal mechanism I would like to suggest is that management buys up shares and an increase in S_i would then

lead to a switch in behaviour. However, as I have no data on ownership over time, this will be left for subsequent research.

²⁶ Again, this abstracts from threats to changes in private rents *c.* Furthermore, liquidity considerations are disregarded in this set-up.

²⁷ This is a similar prediction as the one made by Shleifer and Vishny (1986) who argue that cumulating shares reduces the free rider problem of monitoring management and therefore can make management more likely to maximise shareholders' wealth.

²⁸ If shareholder-unfriendly management could prevent shareholders from increasing their stakes, this could lead to the opposite bias. However, in reality it seems to be the case that management can in general not prevent share transactions among outsiders, but instead might choose not to disclose information etc.

²⁹ See, for example, Shleifer and Vishny (1994). The authors show that public enterprises can be encouraged by politicians subject to pressure from interest groups, such as labour unions, to employ too many people.

³⁰ To some extent it can even be argued that it is a sign of shareholder-friendly behaviour to register a firm in Moscow, as may facilitates it for shareholders to attend the general meeting. Therefore, it is not advisable to control for the region the firm is registered in when running the regressions that are supposed to explain whether shareholder rights are honoured.

³¹ This means, that if two investment funds have a block in a given company, the average includes only the block held by the larger of the two.

³² It should be noted that January 1996 was a point where foreign involvement in the Russian equity market was at its lowest point this

year. Therefore, one would expect much higher values for foreign ownership in late 1996.

³³ It is indeed plausible that the investment needs in the communications industry are particularly high as demand for communications services multiplied with the change of the economic system in Russia. It is also worth noting that the first (and to date only) Russian firm to issue a level 3 ADR was the telecom provider Vimplecom.

³⁴ Including the variable into the subsequent regressions does not improve the fit.

³⁵ Of course, if markets would expect that the other firms were about to honour shareholder rights this would be reflected in the market valuation and the variables in the regression should be insignificant.

³⁶ Nash and Willer (1995) use a different measure for the valuation of some firms in the oil-industry and find that the variable 'Transfer' did help to explain differences in valuation.

³⁷ It could also be argued that high p/e-ratios are the reason for honouring shareholder rights. If high p/e ratios proxied for high investment needs, this could be possible. While this would make it impossible to talk about causation in the above regression, it would be entirely consistent with the above model.

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⁴¹ As a matter of fact, a presidential decree of July, 1, 1996 explicitly states the following: “The capitalization of Russian companies should be increased in the following ways: Implementation of measures to increase the liquidity of the market, mainly by developing a system of protections for investor rights, including ... reducing the costs and risks of the system of securities circulation and servicing, and providing for greater information transparency of the market”.

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⁴³ Furthermore, if the state was believed to hold on to its shares, there would be less incentives to behave in a shareholder-friendly way. This is true as the Law on the joint stock company states that equity issues in firms where the state holds more than 25% can only happen, if the share of the state is not diluted. This would tend to make equity issues less profitable.

⁴⁴ Only in 14% of cases is the stake of the largest outside holder larger than 42%. The negative effect in the case of the very large outside holdings could be due to the fact that management together with the largest outside blockholder own so many shares, that it is impossible to commit not to expropriate minority interests. This might be the case if together they own more than 75% and therefore can change the company charter at their discretion. If there are some arbitrarily small costs of introducing shareholder rights, these firms are then not going to do it.

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