

Corporate governance as political insurance: firm-level institutional creation in emerging markets and beyond

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What do we know about the politics of corporate governance in emerging markets? Although the state-level institutions have been amply explored, firm-level dynamics remain under-theorized. Complementing the orthodox emphasis on external finance as causal force behind the adoption of ‘minority shareholder protections’, the article outlines an alternative mechanism for firms operating in political settings with heightened risk of state intrusion. The Anglo-Saxon governance institutions can serve domestic managers as a strategy to build alliances with foreign stakeholders so as to counteract a dirigiste government. Empirically, the author seeks to explain the implementation of internationally accepted standards of corporate governance by Russia’s big business between 1999 and 2004. The project disaggregates ‘corporate governance’ into specific institutions and examines their quality at the firm level. The causal inference links the shift in state policy vis-à-vis corporate property to the improved treatment of minority owners by the company insiders.

Keywords: corporate governance, institution-building, property rights, emerging markets, transition economies, state-business relations

JEL classification: G3 corporate finance and governance, P14 property rights, P2 socialist systems and transitional economies

1. Introduction

Increasingly, the research on corporate decision-making and control has shifted from the internal organization of the firm to the political context in which corporate conglomerates operate. This study examines the politics of corporate governance Westernization in emerging markets. Departing from the orthodox treatments of external finance as the chief driver of institutional change at the firm level, I conceptualize the range of governance

rules commonly termed ‘shareholder protections’ as an institutional arsenal promoting the political aims of corporate insiders. Western-style governance can serve the insiders in emerging markets as an alliance-building strategy vis-à-vis Western stakeholders, geared to protect the corporation against expropriation by the domestic state.

Empirically, I investigate Russia whose economy had been the nemesis for Western policy advisors and international investors over the 1990s. After a decade of rampant corporate governance abuse and outright theft, the managers of leading Russian firms rushed to introduce international standards of corporate governance, such as the Western accounting principles, independence of board directors, etc. This reversal presents a puzzle ignored in the academic literature. Using unpublished data from a global investment bank and a commercial rating agency, and drawing on author’s interviews, this article disaggregates ‘corporate governance’ into measurable *firm*-level institutions—and shows their *improvement* in Russian big business during the first term of Putin’s presidency. The adoption of international governance standards by Russia’s managerial elites, I argue, is insufficiently explained by the firms’ need for investment. Instead, the thesis links the corporate governance ‘fashion’ among Russia’s top firms to the Kremlin’s attack on the independence of big business.

2. Corporation versus state: a political view of firm-level governance

‘Corporate governance’ is defined as a set of institutions, i.e. formal and informal constraints on behaviour, determining the capacities of firm stakeholders to control the decisions and the cash flows in a given corporation.

The dominant view holds that ‘financial globalization provides. . . incentives for corporate insiders to protect the rights of their minority investors. . . through better corporate governance’ (Stulz, 2005, p. 1598). The adoption of shareholder-oriented governance throughout the world has been linked to the insiders’ need for foreign, often Anglo-American, finance (e.g. Hassel *et al.*, 2003; Shleifer and Vishny, 1997; Durnev and Kim, 2005, Lemmon and Lins, 2003; La Porta *et al.*, 2000). However, the finance approach only inadequately addresses *the politics of corporate governance at the firm level*. The literature on transition countries, in particular, treats external finance as the principal motivating factor for company managers (who decide whether to expropriate the outside owners or to protect them via control-sharing arrangements and stringent information disclosure). The causal connection between improved corporate governance and the inflows of external finance has, incorrectly, assumed

an axiomatic status.¹ Surely, enterprise restructuring may necessitate foreign investment. However, this *macro-structural constraint has been unquestioningly translated into the motivations of firm-level actors* in the literature. I argue, conversely, that the firm-level corporate governance institutions, commonly conceived as ‘shareholder protections’, fulfil a *variety of goals* for the enterprise insiders, some of which are entirely decoupled from the perfunctorily assumed all-trumping financing needs of enterprises.

In addition to their overly narrow treatment of corporate insiders’ incentives, the finance-related approaches overemphasize the benefits of shareholder-oriented governance relative to the very real costs of such institutions *from insiders’ viewpoint*. Such costs can be conceptualized as the ‘costs of discretion’ which are crucial *independently of the monetary costs* of finance (such as IPO fees, dividend payments or loan interest)²: external investors restrict the leeway of insiders in exchange for capital. This point is conveniently neglected by finance-driven theories, which posit the monetary costs of finance as the only factor in insiders’ choice to protect minority owners. The presence of high discretion costs involved in ‘good governance’, however, makes the insiders’ choice to impose restrictions upon themselves much more puzzling than the finance-based theories admit—particularly so in transition environments where various forms of corporate governance abuse have been central to the very survival of firms (Adachi, 2005).

Compared with the firm-level research, the scholarship on nation-level corporate governance more readily includes factors *other than* finance. Three non-financial perspectives have crystallized in this debate. First, the ‘varieties of capitalism’ school presents corporate governance as one of four interdependent spheres in which companies must resolve their coordination dilemmas: nation-specific coordination systems, roughly divided between the liberal and the coordinated types, shape corporate governance (Hall and Soskice, 2001). Second, the research on ‘legal structures’ links formal laws to corporate governance regimes. La Porta *et al.* (1998) derive the extent of formal investor protections from the countries’ historical legal families and find that common law-based regimes protect investors better than civil law systems. Other scholars have focused on electoral rules, arguing that majoritarian systems encourage diffuse ownership, whereas proportional representation generates blockholding

¹‘[T]he development of external finance... provides a useful summary indicator of improvements in corporate governance in the transition economies’ (Pistor *et al.*, 2000, pp. 327–328). Glaeser *et al.* (2001) follow this line by evaluating corporate law development in Poland, Hungary, and the Czech Republic in terms of outside investment.

²Hence, debt finance, e.g. is often preferred to equity by corporate insiders, *even if more expensive in monetary terms*, since creditors—unlike equity owners—do not have control powers in the enterprise (except for bankruptcy cases).

and discourages shareholder protections (e.g. Gouveritch and Shinn, 2005; Pagano and Volpin, 2005). Finally, the ‘political choice’ perspective addresses the interest-group politics of institution-building. Scholarly attention has focused, for example, on the social contracts behind the ‘outsider’ and ‘insider’ governance models (e.g. Jackson, 2001; Dunlavy, 1998). Roe’s (2003) seminal account links corporate governance types (captured via ownership concentration) to the latent labour power and the ‘costs of economic peace’. If high, these factors necessitate a ‘social democratic’ compromise in which managers face political pressures to neglect ‘shareholder value’ by shunning risky investments, maintaining employment, etc. The political choice paradigm also examines the impact of possible coalitions between shareholders, managers and labour (e.g. Coffee, 1990), as well as the influence of equity ownership by voters (e.g. Perotti and von Thadden, 2006) on the national corporate governance reforms.

Their wide-ranging insights notwithstanding, these research programmes leave the *firm-level* dynamics under-theorized by focusing almost exclusively on the state-level legislative and enforcement frameworks: ‘[c]orporate governance systems reflect public policy choices. Countries pass laws that shape incentives, which in turn shape governance systems.’ (Gouveritch and Shinn, 2005, p. 2). This perspective ignores a crucial layer of institutional creation (and creativity)—it is within individual companies that corporate charters, board compositions, equity listing locations and other fundamental governance choices are made. These choices entrench the *de facto* governance practices not captured by the macro-level legal frameworks. Importantly, firm-level institution-building is becoming increasingly consequential for both the advanced capitalist nations and the emerging markets. A German AG, for example, can flee co-determination by moving to other countries and ‘sneaking back’ as a French SA or a British plc. In transition economies, the systemic devolution of corporate institution-building to non-state level has been accelerated by Western advisers’ advocacy of the ‘self-enforcing’ corporate law model in which enforcement powers are delegated from the courts and administrative agencies to the corporate stakeholders. The importance of studying firm-level choices is obvious. On the one hand, institutional shopping by private domestic actors in the global supermarket of ‘best practice’ templates directly, and possibly negatively, impacts the ultimate institutional compatibility at the national level. On the other hand, as stressed here, institutions adopted by corporate insiders alter the nature of state-business relations.

The research on nation-level corporate governance is preoccupied with the issue of global institutional divergence, correctly pointing out that historical and institutional legacies continue to shape the national governance systems. Unfortunately, both sides of the convergence–divergence debate (Gordon and

Roe, 2004) often treat the convergence forces *as if these were limited to and identical with* financial globalization. However, *political* reasons can drive the convergence on shareholder protections as well. While the variation in historical social contracts, labour militancy levels or party-based alliances has been used to explain the *divergence* in corporate governance (Cioffi and Höpner, 2006; Roe, 2003), I argue that politics can also drive institutional homogenization. Furthermore, given the discrete causes of institutional convergence, seemingly identical institutions, once ‘converged’, can have vastly different implications. The ‘negotiated shareholder value’ institutions in Germany, for example, ‘have consequences for the types of performance incentives and employment relations’ when compared with the virtually *identical* institutions in the UK, which are introduced unilaterally by the CEO (Vitols, 2001a, b, p. 350). The same institutions in Russia become ‘defensive shareholder value’ for corporate insiders, as will be argued here. Potential changes in the return on equity must not eclipse major *political* ramifications of ‘shareholder value’ institutions, ramifications that differ across the national contexts.

Crucially, extant research on corporate governance often views the state as an arena for socioeconomic contenders rather than a powerful actor with its own interests. The programme on the varieties of capitalism casts the state in quasi-Marxist terms as the enforcer of producers’ preferences (Wood, 2001). The research examining various alliances between management, labour, and owners reduces the state to a mechanism translating the interests of the winning alliance into policy (e.g. Gouveritch and Shinn, 2006). In general, the literature on the political economy of corporate governance would benefit from the ‘statist’ approach in political science, which treats state elites as a discrete interest group with sufficient autonomy to enforce its own agenda.

Historically, the conflict in state-business relations has centred on the issue of corporate governance both in the emerging markets and in the OECD economies (Stulz, 2005; Vitols, 2001b). Yet the current literature largely ignores state actors as independent participants in this conflict. Russia is well suited to examine the impact of the tension between state and firm on corporate governance institutions. On the one hand, the policies of Putin’s administration have jeopardized the independence of corporate insiders, presenting a clear shock to the status quo of the 1990s as far as firm-level governance goes. On the other hand, the post-Soviet transition has left the Russian labour utterly disempowered (due to the usurpation of employees’ shares by the management during the initial privatization and the adoption of a pro-capital Labour Code in 2001): the exclusion of labour as a key stakeholder in corporate governance allows to zoom-in on state-business conflict proper.

The account presented here also contributes to the rich region-specific scholarship. Unfortunately, the research aiming to identify the predictors of corporate

insiders' behaviour in transition markets has mostly focused on the historically deterministic independent variables (for an exception, see McCarthy and Puffer, 2003). The list of legacies thwarting the adoption of sound corporate governance emphasizes the suboptimal privatization methods (e.g. Woodruff, 2004; Black *et al.*, 2000), the cultural antagonism of managers and labour towards the outside shareholders (e.g. Buck, 2003), or the systemic uncertainty of transition dictating idiosyncratic management strategies (e.g. Stark, 2001). For the most part, such accounts fail to capture, let alone explain, the ongoing *changes* in the institutional forms of governance. At a broader level, the studies of formal law in transition economies seem polarized between the 'convergence' (e.g. Hendley *et al.*, 2001) and 'path dependence' (e.g. Barnes, 2003) perspectives. The former sees legal institutions playing an increasing role in structuring the market transactions; the latter considers the ostensible legality superficial and the informal relations or raw power decisive. In the case of firm-level governance, my account suggests that legal institutions *do* constrain the market participants: the insiders' discretion at many Russian firms has been reduced to the benefit of external shareholders. However, such legality is still embedded in the unregulated property rights relations and serves the idiosyncratic purposes of corporate insiders. It is the paradoxical co-existence and *interdependence* of legality and lawlessness that seem to define many emerging markets.

The argument presented here can now be summarized. The adoption of shareholder-oriented corporate governance at the firm level is by no means a knee-jerk reaction to financial distress or to the pressure of external investors. Managers and blockholders are equally sensitive to the role of the state with respect to corporate property rights. Should the state assume an activist or predatory stance, corporate insiders are likely to give the external minority shareholders some control so as to counterbalance the threat from an intrusive government by creating new alliances. This scenario presents a case of agents (managers) trying to play off several principals (corporate stakeholders) against each other by using institutions (corporate governance) that have acquired broad international support. Focusing on the Russian case, I argue that the adoption of corporate governance institutions by Russia's big business is only partially explained by the firms' need for external finance. Firm-level institutions benefiting foreign minority shareholders have served an additional purpose of protecting corporate property rights vis-à-vis the Russian state. These institutions were often intended as an 'anti-state insurance' by managerial elites after 2000 when the Russian government sent a credible signal that the elites' ongoing rent streams could be imminently and permanently terminated. In reaction, the corporations began adopting minimal governance standards necessary to gain potentially powerful allies against interventionism by the state authorities. These allies include (a) Western financiers whose investments in the domestic corporations become

progressively ‘sunk’ as the threat of government expropriation³ increases, forcing the outside owners to lobby the state, de facto on behalf of—or in unison with—the corporate insiders; (b) the array of foreign governments, think-tanks, media and other public actors able to parlay the enhanced international legitimacy of the new domestic corporate governance champions into pressure on the domestic government agencies willing to expropriate the firm.

3. Measuring ‘corporate governance’: Russia, 1999–2004

Corporate governance abuses in Russia of the 1990s are well documented (e.g. Black *et al.*, 2000). The flak of corporate governance in Russian enterprises continues unabated in the academic literature (Gouveritch and Shinn, 2005; Woodruff, 2004; Barnes, 2003). However, the need to transcend the theoretical focus on ‘legacies’, as well as the empirical necessity to disaggregate the ‘corporate governance’ phenomenon warrant a new look at the evidence. Firm-level governance institutions discussed in this study constitute rules which restrict the discretion of corporate insiders. Generally, such restrictions include the disclosure of internal data (the identity of largest shareholders, the percentage of cross-ownership, etc.), the adoption of international accounting standards, as well as the various minority shareholder-empowering rules involving board membership, the right to challenge managerial decisions in court, etc. The data presented below are categorically distinct from the state-level corporate governance indices used in the literature (Pistor *et al.*, 2000; La Porta *et al.*, 1998), as they refer to firm-level institutions *adopted voluntarily by corporate insiders*. The data focus exclusively on big business; given the radically disparate conditions facing Russia’s exchange-listed blue-chip firms and the large mass of capital-starved manufacturing firms, composite indicators of corporate governance (such as country rankings) are often misleading.

The few available studies using firm-level data on emerging markets’ corporate governance employ the data set compiled by Credit Lyonnais in 2001 (e.g. Durnev and Kim, 2005). Featuring 25 countries, this set lacks longitudinal data. More regrettably, Russia’s rankings are based on the data from only one (!) firm, Lukoil, placing the country as the worst performer, far below Pakistan and Turkey. Although Credit Lyonnais rightly cautioned that its data for Russia are ‘questionable’ (CLSA, 2001, p. 177), the rankings reinforced the wrong impression of stasis, i.e. of continuing egregious governance abuse, in Russian

³Expropriation is defined as the transfer of corporate value among stakeholders, which is (a) not consensual and (b) not transparent or generally applicable. Hence, contractual deals, or a universal application of a standard tax rate, do not count as ‘expropriation’; arbitrary applications of criminal law or ‘company-specific’ taxation do.

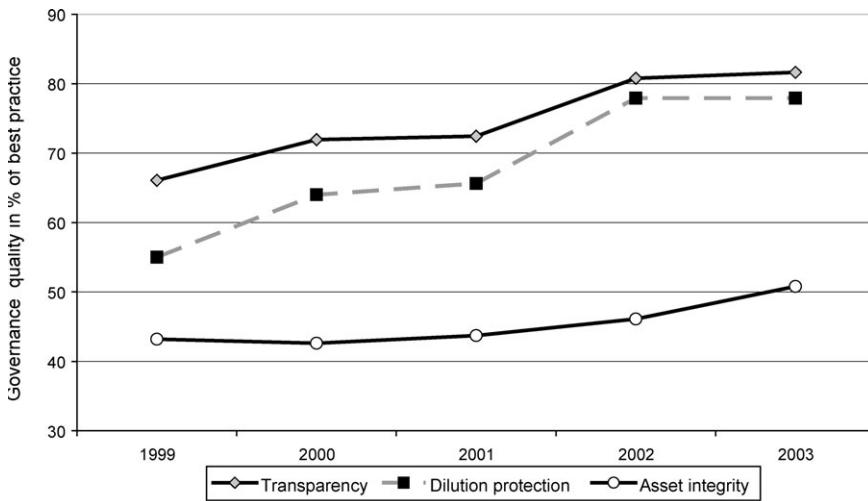
corporate heavyweights. Hence, the data elaborated below fill an empirical gap in the literature.

To examine the overall trend among the 'blue chips' in 1999–2003, I use the data from UBS Warburg investment bank whose coverage grows from 14 to 30 Russian corporations in this period. At the beginning of coverage period, the quality of corporate governance was almost uniformly deplorable; hence companies cannot have been selected 'on the dependent variable'. Instead, Western banks and IGOs routinely monitored economic heavyweights, i.e. main contributors to the GDP: unsurprisingly, these firms were also the chief abusers of corporate governance in the 1990s.

UBS assigns penalty points to firms reflecting the presence or absence of specific governance institutions, such as charter restrictions on ownership or voting, independence of board membership, etc. Overall, the average governance quality for covered firms throughout the period is shown to increase by about a third, representing a non-negligible empowerment of minority shareholders (semi-annual UBS reports, 1999–2003). Triangulation confirms the positive trend. The rankings by Russia's Institute of Corporate Law and Governance correlate strongly with the UBS data, stating a clear progress between 2000 and 2002 (ICLG, 2002).⁴ However, when averaged across companies and institutions, the UBS data are weakened by several factors. First, the inclusion of subjective components evaluated by the bank analyst may introduce conflicts of interest and potentially skew the rankings. Second, institutionally aggregated rankings preclude a more nuanced picture of corporate reorganization. Finally, average improvement across firms may conceal sluggish developments or retrenchment at particular enterprises. To address these issues, I disaggregate the data by institution categories and companies.

Figure 1 presents the trends in three institutional categories of corporate governance between 1999 and 2003 for 19 companies (see Table 1 for company-specific information). The vertical scale represents the degree to which rated companies approach world-class standards in a given category; higher percentage reflects higher governance quality in the given institutional group. To create the scale, the 'penalty points' assigned by UBS based on the presence or absence of specific institutions have been translated into fractions of the maximum (100%) achievable governance levels. By allowing direct cross-institutional comparisons, the scale is more useful than UBS points whose maxima differ across institutional categories. All companies with minimum

⁴ICLG rankings cover 40 companies and feature five observations for each firm. The overall positive trend as well as the hierarchy of best-to-worst corporate governance performers are virtually identically reflected in UBS and ICLG rankings, which is all the more remarkable given the different methodologies used to compile the indices.



Source: UBS Warburg, compiled by author.

Figure 1 Big business institutionalization of corporate governance: Russia, 1999–2003.

3 years of coverage by UBS are included; for these 19 firms, missing annual values are also imputed on the basis of available information for cross-annual sample consistency. This approach results in 285 observations, of which 22 are imputed. Each observation represents the quality of governance in one institutional category in one company in 1 year. Notably, estimates in Figure 1 are more conservative than UBS numbers, suggesting that the averages used by the bank are skewed because of unadjusted selection of units (the number of rated companies grew from 14 to 30 over the years).

The three institutional categories have been shown to bear directly on the quality of enterprise governance in the literature and are based on concrete indicators. ‘Transparency’ category quantifies the quality of accounting, as well as the extent of disclosure vis-à-vis minority shareholders and institutional investors.⁵ Along with opaque accounting, the danger of ‘dilution’ is a key risk faced by investors in emerging markets: when new equity is issued to favoured investors

⁵UBS codes this category via (a) the track record of a firm’s international accounting implementation—firms with several years of US GAAP or IAS standards are rewarded, whereas those consistently rejecting accounting disclosure are punished; (b) the progress on listing equity on US exchanges through the issuance of American Depositary Receipts—firms are rewarded for undergoing exacting disclosure procedures and compliance with SEC regulations required for a US listing; (c) the timeliness of notifications for annual and extraordinary shareholder meetings—corporations that fail to deliver meeting agendas to equity owners, hence blocking their effective participation in governance, are punished; (d) the presence of an investor relations department and the availability of the operating data to institutional investors.

Table 1 Firm-specific institutional changes in governance, 1999–2003

Company	Sector	Coverage period	Overall rank (first year → last year) [†]	Change in governance quality (last year compared with first year) [‡]		
				Transparency	Dilution protection	Asset integrity
Aeroflot	Airlines	2001–2003	0.6 → 0.8	(−14)	+65	(−10)
Baltika	Food	2000–2003	0.2 → 0.3	+07	+12	00
GAZ	Auto	1999–2001	0.4 → 1.0	00	00	+20
Gazprom	Energy	1999–2003	0.9 → 1.0	+43	00	+20
Irkutskenergo	Utilities	1999–2003	0.1 → 0.9	(−25)	(−10)	(−20)
Lenenergo	Utilities	2000–2003	0.1 → 0.3	+14	00	(−10)
Lukoil	Energy	1999–2003	0.6 → 0.2	+29	+20	+20
MGTS	Telecom	2000–2003	0.9 → 0.8	+50	+08	+20
Mosenergo	Utilities	1999–2003	0.3 → 0.9	(−25)	+70	(−20)
MTS	Telecom	2000–2003	0.2 → 0.2	+14	00	+20
Norilsky Nickel	Metals	1999–2003	0.9 → 0.2	+55	+20	+60
Rostelecom	Telecom	1999–2003	0.2 → 0.3	00	00	+10
Sibneft	Energy	1999–2003	0.7 → 0.5	(−21)	+50	+20
SUN– Interbrew	Food	1999–2003	0.4 → 0.3	00	+60	(−35)
Surgutneftegaz	Energy	1999–2003	0.8 → 0.9	+18	(−50)	+20
Tatneft	Energy	1999–2003	0.5 → 0.5	(−07)	+20	+10
UES	Utilities	1999–2003	0.6 → 1.0	+39	+05	(−40)
Vimpelcom	Telecom	1999–2003	0.1 → 0.0	00	+50	(−20)
YUKOS	Energy	1999–2003	1.0 → 0.1	+98	+70	+80

[†]This column compares a company's governance across all three institutional categories with its peers in the first and the last years of coverage (see column to the left). Smaller numbers imply better governance relative to other firms. The scale is from 0.1 meaning 'top 10%' to 1.0 meaning 'bottom 10%'. For example, if a firm drops from top 20% to top 40% relative to its peers between the first and the last years in which this firm was covered, the column will display '0.2 → 0.4'.

[‡]Change in governance quality is disaggregated by institutional category. Each number is the *point difference* between the last and the first year of coverage. For example, if a company's extent of transparency improves from 40% to 60%, the 'transparency' column will display '+20'. Negative changes are placed in parentheses. No change is indicated via '00'.

Source: UBS Warburg, compiled by author.

(often at below-market prices to the insiders themselves), the proportionate stake—and hence control—of other shareholders is effectively reduced. 'Dilution Protection' category in Figure 1 indicates the extent to which governance institutions shield the owners from such risk.⁶ Finally, outright theft or more subtle

⁶The UBS index for this institutional subset is composed of (a) the presence of pre-emptive rights or other anti-dilution protections in the firm's charter (nota bene: pre-emptive rights grant existing shareholders the first opportunity to buy a new issue of stock in proportion to their current equity percentage); (b) the level of disclosure regarding planned equity issues; (c) the institutional ability of outsiders to block unfavourable share issues—companies are punished if insiders hold a 25% blocking stake.

asset diversion have been a scourge for the post-socialist economies where state supervision collapsed giving rise to unmonitored managerial discretion. ‘Asset Integrity’ category assesses the institutional leeway for corporate insiders to engage in transfer pricing, dubious trading techniques and other practices known to create a serious drain on shareholder value: higher value of the index indicates a more restrictive institutional framework preventing asset manipulation.⁷ Together, these three categories describe the extent of institutional limits placed on corporate insiders to the benefit of outside owners.

Figure 1 suggests that the process of enterprise administration improved perceptibly across all three institutional categories. The quality of governance did not improve evenly; although ‘transparency’ indicators rose from 66% to 81% between 1999 and 2003, and ‘dilution protection’ showed a 55% to 78% increase, the ‘asset integrity’ category started at the lowest point and grew at the slowest pace from 43% to 51%. Although the extent of disclosure and protections against control dilution improved steadily from 1999 on, assets remained vulnerable to diversion at a virtually unchanged level until 2002 when the index rose modestly and then experienced a hike in 2003.

Governance dynamics also vary across companies. Firm-level information underlying the discussion of institutional trends above is presented in Table 1. For each institutional category, the table displays simple *change* in governance quality in a given firm between the first and the last year of coverage. Hence, if a company had 60% and 80% transparency scores in 1999 and 2003, respectively, Table 1 will display +20 in the ‘Transparency’ column. In addition, the table indicates the overall performance of a firm across three governance categories, *when compared with all other rated companies that year*: this information is given in two ‘Rank’ columns. The ranking scale ranges from 0.1 for best-governed companies (top 10%) to 1.0 for worst-managed firms (bottom 10%). To take the example of Aeroflot, covered between 2001 and 2003, the rank column indicates that the firm’s overall governance quality decreased as the company dropped from bottom 40% to bottom 20% (0.6–0.8) when compared with its peers in 2001 and 2003, respectively.

Out of 19 companies, in the ‘transparency’ category, 10 companies have improved, whereas five firms became worse; 12 firms enhanced their dilution protections, whereas three let them deteriorate; 11 companies increased the safety of their assets, whereas asset diversion intensified at seven firms—the positive trend clearly spans all three institutional subsets. To note is the spectacular improvement in Yukos, which rose from *the* worst-governed company in 1999 to a paragon of

⁷UBS codes this category via (a) the extent of usage of offshore and/or affiliated trading companies by the firm; (b) the disclosure on trading environment; (c) past track record of controlling shareholder with respect to asset manipulation.

transparency and shareholder protection. Remarkably, the best-governed firms straddle sectors as diverse as energy, telecommunications and food industries.

One crucial component of sound governance not reflected in the three categories is the presence of board directors independent of the incumbent management. The literature views such directors as conducive to effective governance. In 1999, one-third of UBS-rated companies had minority shareholder representatives on board; by 2002, the proportion of such firms increased to more than two-thirds. Crucially, the new directors 'in many cases... were not elected by minority shareholders in the face of management opposition, as was often the case in the past, but *installed by management* in a bid to improve the company's corporate governance'. [my emphasis] (UBS, 2002, p. 14).

Are the improvements in specific companies' rankings mere window dressing by the incumbent management or do they capture a more transparent *modus operandi* with increased shareholder leverage vis-à-vis management? Although any data on Russia's governance standards will leave this question at least partly open, the rankings in this article are based on the presence of specific institutions rather than on the subjective perceptions of market analysts. Sibneft is a case in point. In June 2001, the company stripped the board of directors of the right to increase charter capital and annulled a large bulk of its authorized shares. Both moves were made in response to the Standard & Poor's audit and signalled a substantially decreased risk of share dilution. Concurrently, Sibneft elected three independent directors, including the head of the Naufor brokers association Ivan Trishkin, to its nine-member board. Even more impressively, the corporation announced the record dividend of \$612 million in August, paying out 90% of its 2000 profits and announcing a long-term dividend policy vouching to maintain an average payout ratio of circa 50%. The anti-dilution stipulations, the presence of independent board members and a credible dividend policy were all captured in the original UBS rankings, implying a significant improvement in corporate governance. (Some of these rankings were not included in this article, as they were partially based on subjective indicators.) Such verdict, however, was undercut in October 2001 when Sibneft announced that it had purchased its own 27% stake from the core shareholders in December 2000, only to transfer it back to them in the summer of 2001: *de facto*, this transaction amounted to an interest-free loan to the core shareholders controlled by Roman Abramovich, a high-profile oligarch, raising questions about Sibneft's transparency as the deal proceeded without timely notice to the minority shareholders. On balance, the company's overall ranking improved only slightly between 2001 and 2002 as the losses in 'transparency' and 'asset integrity' categories offset the gains in other institutional clusters (UBS, 2002, p. 8).

The data presented so far leave a number of important questions unanswered. Are the positive trends in governance limited to the 19 surveyed corporations?

Did the improvement stop in 2003? What are the sectoral dynamics? I use Standard and Poor's 'Transparency and Disclosure' reports to zero in on these issues; like UBS data, these reports have not yet been presented in the literature. The annual S&P data, available for 3 years, 2002–4, cover the 50 largest companies with stock listings on Russia's exchanges. The companies receive percentage scores, 100% being the maximum possible disclosure. Conceptually, these scores resemble the UBS data on the 'transparency' category, but the S&P analysis is more detailed, including firms' publicly disclosed data on 89 items relating to ownership structure, investor relations and financial and operational information, as well as board and management structure and processes. S&P's conclusion is aptly captured by the 2004 report title: 'Positive Trend Continues despite Political Obstacles'. As the report points out,

A comparison of the 45 listed companies included in both the 2003 and 2004 studies shows a *meaningful increase in the overall level of disclosure*. . . In 2004, compared with 2003, thirty-six companies have improved their results, with an average improvement of 10 percentage points; six companies have decreased their standards of disclosure, with an average decrease of 9 percentage points. . . It is noteworthy that the top performers Rostelecom (86%), Wimm-Bill-Dann Foods (83%), and Mobile Telesystems (78%), *follow disclosure standards approaching the best international practices* (for example, the composite transparency score for U.K. companies. . . in April 2003, was 71%) [my emphasis] (S&P, 2004, pp. 5–6).

The S&P analysis confirms that the Westernization of governance practices (corporate disclosure being a central element thereof) was an ongoing process in Russia's big business in 2004. These data also convey sectoral trends better by including more firms than the UBS set. As Figure 2 shows, the *direction* of the trend, namely towards greater disclosure, is uniform across sectors, whereas the *levels* of transparency are highly sector-specific, with the leader—telecoms—outpacing the laggard—engineering—almost fourfold in 2002 and almost twofold in 2004. The *pace* of disclosure is also contingent on the sector, with the food industry experiencing a modest 14% improvement and engineering racing ahead by 150% in the course of 2 years when compared with the sectors' respective initial levels. Although some authors have trivialized the enhancement of corporate governance by treating it as an energy-sector-restricted phenomenon, allegedly due to the sector's appeal for foreign finance, figures imply that firms are upgrading their disclosure across sectors, and the energy industries are not even the leader in this process.

Apart from the 'external finance' motivation behind the trend, one may reasonably surmise that the companies are merely complying with increased regulatory pressure, especially since all of the firms in Figure 2 are publicly

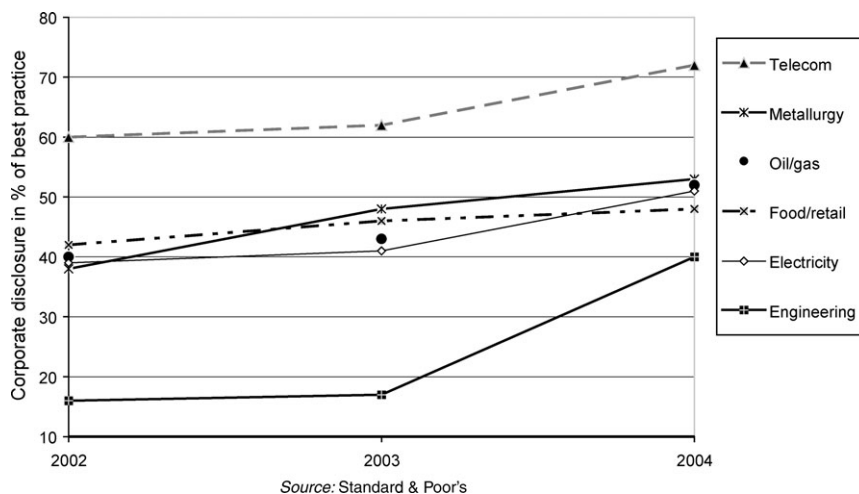


Figure 2 Sectoral trends in corporate transparency: 2002–4.

listed. However, additional data show that the governance improvement extends to the top firms whose equity is *not* traded: S&P examines the 10 largest corporations with illiquid stock (including such heavyweights as Alrosa, Promsvyazbank and Slavneft) and finds that ‘most companies have improved their disclosure standards . . . raising the average [of illiquid firms] to 29% [in 2004] from 18% in 2003’ (ibid., p. 6). Furthermore, S&P quantifies the sources of corporate transparency, allowing to differentiate between obligatory and voluntary disclosure. In 2004, 34% of the publicly available corporate data were provided via regulatory filings with the authorities, whereas 89% was made available through companies’ websites and annual reports, i.e. in a *non-mandated* fashion. (The sum of percentages is larger than 100 since some of the disclosure items are provided via multiple channels by corporations.) Since 2002, the amount of voluntary disclosure grew by 24% (ibid., p. 4). Considering that even when required, Russian companies had traditionally withheld information, these data suggest that corporate elites *chose* to open their governance arrangements to public scrutiny. This insight is further substantiated by the extremely concentrated ownership structure of the firm sample, precluding the possibility of minority shareholder pressure as a key factor. Prima facie, the puzzle of why the corporate insiders would voluntarily incur significant costs of discretion remains unresolved.

4. Foreign finance or domestic politics: questioning causality

Defying its thuggish image shaped over the 1990s, Russia’s big business palpably reduced asset diversion while embracing greater transparency and minority owner protections between 1999 and 2004. The dominant approach to firm-level

governance would provide a ready explanation for this phenomenon: companies seeking external funds, the argument goes, must establish good reputation to raise cash at favourable conditions. While the finance theory undoubtedly accounts for some variance in the Westernization of corporate governance among Russia's blue chips, the factors presented below beg serious questions regarding its overall explanatory power.

To begin, the conventional assumption about domestic managers' motivations is problematic in light of the 2001 survey of corporate governance in listed firms. The study, conducted by the Russian Institute of Directors, demonstrates that the top managers of a hundred Russian companies were prepared to adopt modern governance standards *even if* they were not sure it would help them attract investment (RID, 2001).

Furthermore, the qualitatively higher availability of domestic finance and the enhanced liquidity of debt markets after 2000 suggest that the stampede of Russian companies to foreign equity rests on factors other than pure hunger for capital since the latter can now be secured through alternative sources. Three developments have replaced foreign equity as the only finance option for big business.⁸ First, the skyrocketing oil prices ensured a steady rise in wealth at home, attracting volumes of *domestic* investors to equity. Second, public perception of the financial system's stability has improved after the 1998 crisis, leading to larger deposit volume and lending activity by banks. Most importantly, the corporate bond market took off spectacularly after 2000 from virtually nil and was valued at \$20.8 billion by 2004. By providing corporate leadership with alternative investment sources cheaper than foreign equity (in terms of capital *and* discretion costs), these developments invite doubts about the imperative of external finance forcing managerial elites into accepting constraints on their own discretion.

The peculiarities of Russia's corporate landscape, too, undermine the plausibility of the finance thesis. The defining trend in Russia's big business today is its ongoing consolidation in a ruthless process of empire-building. The oil boom and rising asset prices have made illegitimate property takeovers more attractive. Unlike the 'hostile takeovers' known in the West, Russian takeover tactics use extra-legal means and destroy enterprise value. A formidable 'raider industry' has sprung up, fielding top lawyers, political connections and cash reserves (Profil', 2006). Official figures put the asset value currently disputed in Russian courts above \$4 billion; the value of contested property outside of judicial channels is likely to be several times higher. *Such environment militates against the key assumption of finance theory, namely that the era of 'primitive capital accumulation' in Russia is over, allegedly allowing managers to focus on attracting investment rather than on defending their business structures.* The well-known tycoon Bendukidze (the largest owner

⁸ Author's interview with the director of the Firebird hedge fund specializing in ex-Soviet economies.

of United Machinery OMZ) confronted World Bank delegates from the corporate governance task force by capturing trenchantly the *spetsifika* [idiosyncrasy] of upgrading governance standards in Russia:

Listen: I know you want to teach us how to brush our teeth and hold the knife and fork, but let me tell *you* about corporate governance: I had quarterly [U.S.] GAAP [accounting] results—my deputy CEO was shot in the back of his head in his car; I had 2 independent board members—they resigned. And my market cap is below my annual sales level. So don't tell *me* about corporate governance.⁹

Finally and crucially, the finance-based account of firm-level institutional change neglects the presence of the Russian government, portraying the institutionalization of corporate governance as a bilateral deal between corporate insiders and foreign investors. Yet the Russian state has played a central role in the process. How so? The state failed to play a constructive role in encouraging firm-level governance modernization. The much-discussed Corporate Conduct Code, passed by the government in 2001, has remained the brainchild of the Federal Commission for Securities Markets' chairman, barely known to the business community and legally non-binding.¹⁰ Although the state failed to directly promote equitable and transparent governance, the Russian government has played a crucial *indirect* role. The reassertion of state control over the economy has galvanized companies to hedge against political risks: Western-style corporate governance at the firm level can be conceptualized as a form of 'insurance'. By enhancing its leverage vis-à-vis big business, the state has forced the latter to seek new allies which, in turn, prompted institutional firm-level changes.

Since the end of the 1990s, Russia's economic policy shifted towards the reassertion of state capacity and the speed-up of structural economic reforms. Concurrently, the Kremlin has 'encouraged' big business to contribute financially to the welfare system while politically exploiting corporate wrongdoings to keep the oligarchs in check. Furthermore, the role of the Russian state *as a shareholder* has changed in the joint-stock companies where, in contrast to state enterprises, the non-state shareholders enjoy the same legal rights as the government. Some of the most prominent Russian corporations belong to this category¹¹; unsurprisingly,

⁹Quoted by Fidelity Investment's long-time activist in Russia's corporate affairs, head manager of the Emerging Markets Equity Funds (author's interview).

¹⁰Two years after the Code's initiation, less than a third of executive managers knew about the Code's existence, and only 4% were familiar with its details (Guriev *et al.*, 2005, p. 29).

¹¹Best examples include Gazprom (state owns 38%), RAO UES (55%), Tatneft (33%), Aeroflot (51%), Transneft (75%), First Channel (39%), ALROSA (37%), Svyazinvest (75% minus one share) and Sberbank (64%) (OECD, 2005; companies' websites).

these firms have become an arena of contention as the government moved to solidify its control over the commanding heights of the economy. Multiple studies suggest that the size of partial stakes owned by the Russian state is increasing (OECD, 2002, pp. 81–88). The prime Russian business association, RSPP, expressed concern at its 2006 congress about the ‘expansion of state property’s share in the economy, the drastic increase in the state share of the capital market, and the activity of state monopolies. . . buying up private equity stakes’ (Gazeta.ru, 2006). This pattern has resulted in a network of pyramid-like government stakes under the aegis of holding companies: the government now often controls the parent company that, in turn, may have a controlling stake in its subsidiaries. ‘Although formally such companies do not qualify as SOEs, in actual fact, the state actively interferes in their administration. Some of them report directly to the managing bodies of their parent company bypassing their own boards, in others there are public officers in the membership of the board.’ (OECD, 2005, p. 3). In several corporations, such as RAO UES or Aeroflot, the interests of the government have clashed directly with those of the ‘oligarchs’, and the state has employed a range of strategies to marginalize the private shareholders. (According to author’s interviews with the chief executives of a US hedge fund specializing in transition economies, the Kremlin used Gazprom, the state-controlled gas monopoly, as a financing vehicle to buy out the oligarchs at RAO UES. In Aeroflot, the government wrought control from the mogul Abramovich using the National Reserve Bank and installing a Presidential aide as the board chairman.)

Analysts may reasonably debate whether the incentives of the Russian state are quintessentially developmental or predatory in nature. The organizational intra-state complexity allows for the co-existence of ‘developmental’ and ‘predatory’ bureaus and changes in the outlook of any particular state agency. In some instances, the state was able to reduce corruption after advancing its position in a firm, and Putin is clearly interested in the creation of national champions. The presidential administration has also productively cooperated with business associations on a wide array of legislative reforms (Markus, 2007). At the same time, informed institutional investors fear that the corporations in which the government has reasserted control may fall prey to the personal interests of political elites.¹² What is beyond doubt, however, is that corporate elites’ powerful positions inherited from the free-wheeling Yeltsin era became jeopardized by

¹²As one interviewed hedge fund executive noted, ‘these firms are not really going to be owned by the state—they are going to be owned by people who are in the Kremlin today—who expect to leave the Kremlin and will personally own things that are being effectively held for them in trust by affiliated parties. . . There is a *new group of oligarchs emerging out of the new Kremlin*. It’s a lot of people—and there are a lot of companies they are getting their hands on.’

state ‘activism’. The Russian executive could not commit to predictable law-governed relations with big business (Tompson, 2005).

Notably, for the orthodox finance-related explanation of firm-level governance, the concurrent increase of state pressure on firms and the companies’ adoption of Western governance practices present an anomaly. The S&P’s 2004 report correctly portrays *its own findings as puzzling* from the cost-of-capital perspective:

[The] 2004. . . improvement in disclosure standards. . . *is particularly intriguing given the increased tension between the business community and the state bureaucracy.* . . This. . . could have potentially *negatively affected the inclination of individuals and firms to disclose their ownership structures and otherwise decreased their standards of disclosure.* Yet. . . S&P’s Governance Services index of transparency among the largest Russian companies has increased to 46% from 40% in 2003, and from 34% in 2002. [My emphasis] (Standard & Poor’s, 2004, p. 2).

Conventional wisdom posits the Russian state as a negative force in corporate governance. Conversely, I argue below that the quasi-dirigiste shift in state policy has *positively*, if *inadvertently*, influenced the trajectory of corporate governance in Russia by forcing corporate elites into institutional engineering at the firm level so as to forge political alliances abroad.

5. Shareholder protections as political insurance

Vimpelcom, one of the leading wireless operators in Russia, has consistently topped the corporate governance ratings compiled by various agencies¹³ and was the first Russian company since 1903 to list its equity on the New York Stock Exchange. The year 2004 proved very tense for company’s relations with the state, even by Russian standards (*Kommersant*, 2004). In January, as a result of an unscheduled inspection, the state regulators for telecommunications informed Vimpelcom it did not have the proper license for its 5.5 million subscribers in Moscow. In February, a criminal case was opened against the company by the Procuracy of the Northern Administrative Region: allegedly, the corporation was engaged in ‘illegal entrepreneurship’ with its subsidiary. In the summer, Vimpelcom experienced a deficit of approved phone numbers for its subscribers; the company claimed this was due to the state organs’ intentional blockade. Without any explanation, the firm was also refused a license for the Far East region (which was necessary for nationwide coverage).

¹³The company was ranked first across all institutional categories by UBS Warburg throughout the coverage period 1999–2003; it also improved its rank from fifth to fourth out of 50 companies in terms of transparency from 2002 to 2004 as rated by S&P.

The final note in the crescendo of state attacks came in September 2004 when the firm was presented with a \$157 million back-tax bill (for 2001) by the Federal Tax Service. Nominally, the company was cited for having neglected to pay taxes owed by its fully owned subsidiary Impuls. Realistically, analysts pointed to the long-standing conflict between the Vimpelcom's controlling shareholder, the Alfa Group run by the powerful mogul Mikhail Fridman, and Russia's Minister of Communications, Leonid Reiman (ibid.). The fact that Alfa Group had publicly accused Reiman of corruption seemed to justify expectations of a full-blown showdown. In fact, the conflict between the corporation's main shareholders and the state had even deeper roots. In August 2003, Alfa Group purchased a blocking stake in its rival firm, Megafon, which had been under the control of Telecominvest: highly unusual, the purchase constituted a de facto hostile takeover after which Alfa Group was able to 'fully paralyze the activity of its competitor by applying its veto to all decisions of the board of directors' (*Delovaya Nedelya*, 2003). Inauspiciously, for Vimpelcom, Telecominvest had been backed by the St. Petersburg power elite, which supplied the current government with many cadres, including President Putin. Telecominvest, perceived by many analysts to be still under the personal control of Minister Reiman, challenged the purchase by Alfa Group, and both commercial structures have clashed in a series of international lawsuits (*Vzglyad*, 2005). Given this background, *Kommersant* (2004) at the time concluded that 'the tax persecution of Vimpelcom is related to the conflict of its shareholders with the state regulators of the sector'. AC&M Consulting commented that 'the company can appeal the demands of tax organs in court, but the... probability that the tax authorities will nevertheless obtain the full sum from Vimpelcom is quite high (ibid.)'. Vimpelcom's shares on NYSE plunged by almost 25% after the announcement of the tax claim, underscoring market pessimism regarding the outcome of the company's clash with state structures.

The denouement of the Vimpelcom drama startled all observers. The authorities scaled down the tax bill to \$17 million, i.e. *almost tenfold*, although the firm did not turn to courts on this issue (*New York Times*, 2005). Also, shockingly, Reiman was removed from his post over the Vimpelcom battle, despite his ties to Putin (*PriMetrica*, 2004). What happened? Vimpelcom's management, it turns out, employed a political strategy which relied on the company's image as a westernized corporation with transparent accounts and relatively empowered minority shareholders. It is the foreign investors who came to the firm's defence after the tax assault. Through a series of purchases, the Norwegian phone company Telenor came to own 30% of Vimpelcom by 2001. Telenor lobbied the Kremlin—successfully—on Vimpelcom's behalf (*New York Times*, 2005). Dag Vangsnes, Telenor's director, emphasized in an interview to the Russian press that 'Vimpelcom is an open, transparent company which is working for the well-being of Russian people. The attempt of the Russian

authorities to claim these taxes now. . . is an attempt to charge the same tax twice.' (*Kommersant*, 2004).

The real boon for the Vimpelcom–Telenor alliance was the fact that the Norwegian firm is itself 54% owned by Norway's government. The use of political connections by Telenor to defend Vimpelcom against 'tax terrorism', as a leading Russian economist Yasin puts it, is striking. It is noteworthy that *until* the intervention of Telenor, Vimpelcom was hardly effective at countering state bias: earlier in the year, the regulators had turned down all of the firm's 97 legitimate requests for additional bandwidth. This contrasts sharply with a comparable dispute in 2000 when Vimpelcom was fighting a move by the Communications Ministry to strip the firm of its frequencies in favour of a competitor. In this instance, Telenor representatives conveyed the problem to Norway's Prime Minister Jens Stoltenberg who asked his Russian counterpart, Kasyanov, 'to look into the matter' (*ibid.*). Vimpelcom retained its frequency spectrum.

Westernized governance standards and the support of powerful foreign owners can be a mixed blessing for the incumbent management, however. When the interests of minority shareholders and controlling owners (on whose behalf firms are often managed in Russia) diverge, the empowerment of minority owners can backfire. Throughout 2005, Telenor vehemently resisted Vimpelcom's expansion into Ukraine as intended by Vimpelcom's main owner, Alfa Group. Through its 'super-majority' provisions, Vimpelcom's charter effectively guarantees Telenor veto powers on the board of directors. Forced into a corner, Alfa Group had bombarded Telenor with four lawsuits to render the charter provisions invalid (*Izvestiya*, 2006), after which it turned to less legitimate tactics. In February 2006, 'a more than peculiar declaration' amorphously named 'On Russian-Norwegian Economic Relations' was born in the lower chamber of the Duma (*Novye Izvestiya*, 2006). The document labelled Telenor's resistance to Vimpelcom's presence in Ukraine as 'a dangerous precedent when a foreign investor in Russia not only fails to promote its economic growth but also negatively influences the development of bilateral and multilateral economic relations' (*ibid.*). The lack of Alfa's fingerprints on the proposal cover notwithstanding, its authorship left few doubts. Notably, a similarly murky tactic was used by Alfa Group in 2005 to prevent Telenor from increasing its equity stake in Vimpelcom to 45%. Then, the Russian security services 'recommended' the Federal Antimonopoly Service to block Telenor's entirely legitimate move in what constituted 'the implementation of private, corporate interests through the hands of an authoritative state structure' in the words of a Duma deputy (*ibid.*).

Telenor has prevailed over Alfa Group, however. The dubious Alfa-lobbied declaration was recalled in the Duma by the Chair of international affairs committee preceding the visit of Norway's foreign Minister (*ibid.*). Vimpelcom was

forced to officially retract its Alfa-supported offer to purchase Ukraine's Kyivstar because of Telenor's resistance (Vimpelcom's press release, 1 June 2006). Finally, the Federal Antimonopoly Service director conceded Telenor the right to increase its stake in Vimpelcom after much futile pressure from Alfa Group (Prime Tass, 2006).

Corporate insiders seek influential foreign allies—but the discretion costs involved in westernizing corporate governance can prove too high in retrospect. However, once institutionalized through corporate governance enhancement, the shifts in the balance of power at the firm level are hard to undo. Ideally, the incumbent management would prefer internally passive but externally powerful minority shareholders—those who could defend the firm against state harassment yet take a backseat with respect to company's internal affairs. Needless to say, few external investors would entertain such prospects: minority owners' empowerment becomes path-dependent after its institutionalization.

Vimpelcom's case is not exceptional. Most corporate governance pioneers in Russia's big business have found that empowering foreign minority owners pays critical *political* dividends. In 1999, for example, the Russian oil firm Sidanco came under the operational control of the global giant BP; although owning only 10% of shares, BP occupied almost all seats on the board. This turned out an advantage for Sidanco when the more powerful corporation TNK began buying up Sidanco's debts so as to usurp the control of Sidanco's Chernogorneft subsidiary. (For more details on this case, see NGFR, 2005.) After TNK refused BP's demand to return the subsidiary to Sidanco, BP turned to the US government with a request to defend its legitimate interests. In response, the US State Secretary wrote a letter to the ExImbank (US government-affiliated credit agency), which at the time was completing a contract with TNK to offer the latter credit guarantees in the amount of \$600 million. The State Secretary 'insistently urged' the ExImbank to block all guarantees to TNK, which the bank did. In parallel, BP filed lawsuits against TNK in Russian and international courts. TNK bowed to the pressure—which Sidanco alone would have never been able to mount—and returned the subsidiary. More well known is the ongoing use of BP's political muscle in the TNK–BP joint venture (established in 2003). Like Vimpelcom, this alliance of foreign and Russian capital was subjected to escalating pressure by Russian regulators: in early 2005, TNK–BP faced a back-tax claim of circa \$1 billion. This figure prompted BP CEO John Browne to visit president Putin and other top Kremlin officials personally in late April to discuss the fate of BP's investments in the country. BP was able to reduce the tax bill to about one-fourth of the sum demanded (*Russia Journal*, 2005).

The rightful objection may be raised that—if corporate governance improvements were, indeed, partially intended as anti-state insurance—then the governmental takeover of Yukos in 2003 starkly demonstrated the limits of 'coverage'.

(In a highly politicized trial, the state expropriated the entire 59% stake from the controlling shareholder Khodorkovsky, allegedly as a retribution for tax evasion.) Two points are worth noting. First, a whole range of foreign stakeholders *did* come to support the beleaguered corporation. Most spectacularly, the firm was allowed to file for Chapter 11 bankruptcy protection in the USA, as one of its American executives had opened bank accounts in the name of 'Yukos USA' in Houston. The court in Houston ordered a 10-day delay in the auction of Yukos's key asset, Yugansk—this decision prompted an international banking consortium, '*fearing legal action in U.S. or international courts*', to cancel its deal with the Russian state proxies aimed to finance the government's purchase of Yugansk (Barnes, 2006, p. 212). The improvement in corporate governance of Russia's Yukos has also paid off handsomely in the way the company's conflict with the Russian government was covered in the Western media. As Khodorkovsky's stand-off with the Russian authorities escalated, the tycoon enjoyed the firm support of Western interests: the improvement in corporate governance was crucial to subdue Western memories of the criminal abuses of law by the company throughout the 1990s. Tellingly, the *Economist* lashed out against Putin's overall record by stating that 'the attack on Yukos, *the best-run and most western-looking of Russian companies*, was the worst of all' [my emphasis] (*Economist*, 2004, p. 9).

Second, the fact that the firm was nevertheless expropriated can be considered *sui generis* given that the company's main shareholder, the richest man in Europe at the time, directly crossed Putin's plans and refused to back down on several occasions. (While the press publicized Khodorkovsky's donations to opposition parties, some analysts pointed to the ex-CEO eying the president's seat.) It should be obvious that most firms have neither the resources nor the ambition to personally challenge Russia's president. By the time of Khodorkovsky's stand-off with Putin, the latter had repeatedly demonstrated his ability to prevail over the oligarchs (two high-profile oligarchs had fled the country). The Yukos take-over does illustrate that no matter how westernized its corporate governance, big business loses in a head-to-head confrontation with Putin. However, such grandiose plots are not exactly on the daily agenda of Russia's corporations. The alliance-building strategies involving good corporate governance do not always protect the corporate insiders from governmental interference. The more modest claim is that improved corporate governance does *create* alliances between the external stakeholders and the corporate insiders and that such alliances have been effective to check the encroachment on corporate property rights by the state in cases outside of the personal Putin-oligarchs feuds.

Abstracting from the Russian case, a theory of defensive corporate governance internationalization must answer two questions. First, what are the political conditions under which the domestic corporations are likely to adopt foreign

governance institutions? Second, just when is the import of such institutions likely to shield the domestic firm from state interference? I offer several preliminary answers.

First, corporate insiders are more likely to invest in alliance-building strategies, e.g. via corporate governance adjustments, when the present value of the costs associated with a potential state expropriation begins to exceed the present value of the benefits that the insiders derive from expropriating minority shareholders. In other words, when the risk of state intrusion becomes too high to ignore, insiders are more likely to give up the private benefits of control by aligning their interests with minority shareholders and committing credibly to this alignment. Such defensive strategy will substantially reduce the insiders' discretion. Hence, it is likely to be the strategy of the last resort. The insiders are likely to self-impose 'proper' corporate governance only after other, less costly (in terms of discretion), strategies—such as media or philanthropy campaigns to garner public support or the use of off-shore holding companies to conceal assets—prove futile.

Second, the defensive adoption of 'best practice' shareholder protections at the firm level is more likely to actually protect the firm from state expropriation when two conditions are satisfied. To begin, the new foreign allies must be both capable *and* visibly committed to inflicting costs on the domestic government should the latter expropriate the firm. From the corporate insiders' viewpoint, foreign investors vary not only along their finance conditions, but also according to their *political* capital, i.e. the support the foreigners could provide should the firm face administrative discrimination at home. For example, the political links of the foreign firm to *its own* government definitely carry a big premium for the corporate insiders, as the Vimpelcom's case shows. (The shape of such links goes far beyond direct state ownership; in the USA, for example, many private hedge funds intentionally employ high-ranking state officials to have access to crucial political networks.) IGOs can also be effective at 'insuring' the companies politically, as the head manager of the Emerging Markets Equity Funds at Fidelity Investments conveys (author's interview):

a lot of Russian companies like to have EBRD [European Bank for Reconstruction and Development] as shareholder because it provides protection. . . if you find that EBRD has a stake in a company, it's hard to shake down a company because you'll have all EU governments involved, and it's a pain. . . , so they [the Russian state officials] don't do it.

It is not enough for the foreign organization to be capable of wielding influence over the domestic state officials: it must also be committed to doing so. The organization's internal rules, its ethos, or its investment strategy can bar it from taking an active part in any disputes abroad. Fidelity Investments, for

example, became the third-largest owner of Vimpelcom in February 2004; however, unlike Telenor, this institutional investor did not take any part in Vimpelcom's imbroglios with the state, due to Fidelity's internal norms (author's interview). Yet other investment funds, such as Prosperity or Hermitage, have actively defended the property rights of the Russian firms in which the funds held stakes. Corporate insiders cannot be disinterested in the foreign investor's preferred response to potential political threats at home—'exit' through selling the stake or 'voice' through engagement could make all the difference.

The other condition for the effectiveness of defensive corporate governance stipulates that the domestic government must perceive the costs that can be imposed by the allies of corporate insiders as being higher than the benefits from expropriation. In other words, the potential benefits of expropriation by the state must not be excessively high, as this would make the government insensitive to the costs the foreigners could impose. If the enterprise finds itself in a strategic sector, or a particular corporate insider has sky-high political ambitions jeopardizing the state elites, the government may willingly bear the consequences of expropriation to ensure its own survival and maintain given policy priorities.

Rather than being viewed just as a finance instrument, westernized governance in emerging markets' firms should be examined within a broader range of tactics devised by corporate actors to protect their assets in risky environments. Such *political* tactics may appear to be driven by 'economic' or 'social' considerations. Consider how Yukos employed philanthropy and trade, for example.

With charitable donations exceeding \$50 million annually across a broad range of causes (*New York Times*, 2003), the ex-CEO Khodorkovsky could teach Dale Carnegie a thing or two about how to win friends and influence people. The magnate's lavish spending in Washington gained him access to the top-level US policy-makers, including several senators and Bush senior. As foreigners are barred from donating money to the American political parties, Khodorkovsky focused on the US think-tanks and organizations, 'including a \$1 million donation to the Library of Congress and a \$500 000 pledge to the Carnegie Endowment for International Peace'. (ibid.). Fiona Hill, a Russia analyst at the Brookings Institution, noted that 'the [American] think tanks were all joking about who wanted to take money to fund the Mikhail Khodorkovsky chair of good corporate governance'. Although the cross-national philanthropy can be instrumental in building alliances for a corporation, so can the good old trade. Even with Khodorkovsky in jail, Yukos manoeuvred skilfully to prevent further expropriation by the state. On the eve of a 2004 Russo-Chinese summit, the company announced it would cut its oil exports to China 'because, with its accounts frozen by the government, it could not finance the... cost of shipping...'. (*New York Times*, 2004). The analysts agreed that

[The] Yukos move humiliate[d] the Kremlin at a critical juncture. . . While only marginally important to Yukos's bottom line, the export cuts. . . are a serious embarrassment to. . . Putin, who. . . pledged to allies and the international community that Russia would not disrupt oil exports to global markets. . . [This was] a masterly chess move for a company on the defensive in a tense match with the government. . . : *Now the Russian government has to explain its actions regarding Yukos – not only to its own courts, but to foreign governments like China* [my emphasis] (ibid.).

Domestic firms create new political realities via ostensibly 'financial' institutions. In conclusion, let us note that the corporate world is ripe with pertinent examples awaiting comparative analysis. In China, some domestic firms seek FDI primarily to gain a more privileged legal status at home (Huang, 2003, pp. 313–325). More intricately, nominally private spin-offs of state-owned enterprises in mainland China aim to have their equity listed in Hong Kong or New York in order to thwart the attempts by the parent state holding to control the quasi-private subsidiary.¹⁴ Such control is made more difficult because of the stringent reporting requirements credibly imposed on the enterprise by the stock exchange regulators outside of Beijing's reach: the tunnelling of funds from a Chinese firm to the loss-making parent enterprise cannot proceed undiscovered once the firm lists abroad and is 'forced' to adopt internationally accepted governance standards. Fascinatingly, a structurally similar dynamic was observed in Germany. There, many firms sought to list their equity on the New York Stock Exchange in order *to be forced into transparency* since the latter would make it obvious that some subsidiaries were more profitable than others, hence increasing managerial power to reduce the cross-subsidization of subsidiaries common in Germany.¹⁵ While the adoption of international accounting standards at the firm level achieves the same purpose also without an NYSE listing, the latter can be presented by management to transparency-opposing parties as an exogenously placed constraint outside of the managerial control. Like the corporate governance reforms, the cases of FDI and foreign equity listings cannot be assumed to be finance-driven *a priori*. The institutions of corporate finance have tremendous political impact on the power relations between the firm stakeholders, including the state. Hence, it is plausible that in some instances such institutions will not emerge as an adjustment to finance imperatives—but will rather be engineered as a conscious political strategy.

¹⁴On the basis of one author's field research in China (September–December 2005). For details on the 'spin-off' phenomenon, see Oi (2005).

¹⁵I am indebted to Peter Hall for this point.

6. Conclusion

Extant treatments of corporate governance in emerging markets posit the firms' hunger for investment as a perpetuum mobile of institutional convergence. This piece, without denying the importance of capital for managerial decisions, has sought to identify the political factors influencing the changes in corporate governance. On the basis of the firm- and institution-specific data, the descriptive inference outlined a substantial improvement of firm-level governance across big business in Russia, countering the negative assessments in the literature. Questioning the exclusive role of finance-related motivations behind this improvement, I conceptualized western-style corporate governance as an institutional toolkit providing 'weapons' for the domestic actors engulfed in property rights struggles in an uncertain environment. By adopting internationally accepted governance standards, corporate insiders secure the support of foreign stakeholders in the potential conflicts over property rights with the domestic state agencies.

The evolution of institutions *at the firm level* has been unduly neglected in the nascent 'political' scholarship on corporate governance which prioritizes national frameworks as the relevant level of analysis. Corporate governance is a unique organizational nexus in which institutional initiative lies at *both* the state and firm levels: state-level rules establish a common denominator, a regulatory floor upon which any corporation is free to 'build' via firm-specific corporate charters, choices of disclosure level, etc. Future work would clearly benefit from an integration of both analysis levels. Furthermore, the literature may be focused too intensely on the finance-related pressures behind the firm-level convergence of governance standards. While various *external pressures* on management have been suggested as the drivers of shareholder-oriented firm governance, e.g. the pressure by Anglo-Saxon institutional investors, national legislation simplifying hostile takeovers or the labour pressure to hold management more accountable, the *voluntary self-imposition* of institutional restrictions by management is invariably interpreted as a strategy to raise capital. Such assumption must not be made a priori, however, as this article suggests. In poorly institutionalized emerging markets especially, *political* capital is at least as critical for firms' survival as cheap finance. Internationally accepted governance standards help build political capital.

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