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THE UNINTENDED BENEFITS OF EMPOWERING BOARDS IN CONGLOMERATES: THE CASE STUDY OF AFK SISTEMA[4]

This paper investigates the role of boards of directors of conglomerate subsidiaries in emerging markets. The paper based on a case study of AFK Sistema—a large diversified Russian business group including subsidiaries in 15 sectors. We show that creating corporate governance institutions at the subsidiary level can have unexpected advantages for the group as a whole and can be used to improve the quality of decision-making in the group. Sistema implemented corporate governance at this level to attract capital and to satisfy the demands of the minority shareholders, but over time started to use the already established institutions of the corporate governance as a tool of corporate management.

GEL classification: G34, L25, M10

Keywords: diversified corporation, board of directors, parent company, subsidiary, corporate governance, corporate management, emerging markets

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1. Introduction

The predominance of informal governance practices in emerging markets is widely acknowledged in the literature (Puffer and McCarthy 2011; Estrin and Prevezer 2011). The quality of law and law enforcement in emerging markets is poor, as is, in many cases, knowledge of legal institutions and corporate governance design options by company stakeholders; formal and transparent structure can, in some cases, even attract a predatory government increasing risks for the private business (Libman et al. 2016). The high volatility of emerging markets makes it necessary to make decisions swiftly and without any bureaucratic delay; formal corporate governance mechanisms can stand in the way of this flexibility. Business partners typically expect transactions to be organized in an informal manner. However, over time, informal governance mechanisms may be insufficient. The companies need to develop formal governance mechanisms: this often happens if they need to attract capital from international markets, where formal governance is a necessary precondition for attracting investment (and for being listed in the first place).

The restructuring of the business and governance structure in order to satisfy the requirements of external (especially international) investors frequently places companies from emerging markets in a difficult position, as the introduction of formal corporate governance can clash with their established informal internal decision-making mechanisms. Those who attempt to internationalize their business first face a particular problem because for them combining transparency and organizing relations with traditional (still non-transparent) business partners and a (predatory) government is particularly difficult. Corporate governance is therefore one of the examples of the complex interrelation between the internal business logic of emerging market companies and the expectations of the global capital markets – furthermore, investors can demand a stronger industrial focus of the business group, which is at odds with the specifics of emerging markets where transactions outside the group are prone to very high risks. However, besides satisfying the expectations of investors, formal corporate governance also plays an important role in improving the quality of decision-making, for example by having independent directors. While the traditional literature highlights their monitoring function vis-à-vis company management (relevant, in particular, for companies with dispersed ownership), the resource dependence approach (Hillman and Dalziel 2003) shows that independent directors can play an important role in providing resources, e.g. using their contacts, reputation and market expertise. As a result, the expertise of directors improves the quality of managerial decisions and thus the company performance (e.g., Zahra et al. 2009).

Large business conglomerates, which are typical for many emerging markets, form a particularly interesting case from this point of view. For conglomerates, there are additional options for acquiring capital from international markets, as they can do it both at the level of the group and at the level of individual subsidiaries, e.g., through IPOs. In the latter case, introducing formal corporate governance mechanisms becomes especially important, partly to satisfy the formal requirements of stock exchanges, but also because it is unacceptable for investors to acquire shares in a company with a majority shareholder (the conglomerate parent company) without clear and transparent guarantees; Young et al. (2008) highlight the importance of 'principal-principal' conflicts (i.e., the abuse of the interests of the minority shareholders by the majority shareholder) as one of the key rationales for introducing formal corporate governance in emerging markets. At the same time, subsidiaries have to remain the part of the overall corporate management structure of the group; formal corporate governance mechanisms can clash with these management structures, if they are based on informal and non-transparent relations.

This paper shows that creating corporate governance institutions at the level of subsidiaries can have an unexpected advantage for the group as a whole and go beyond the traditional function of organizing relations with external investors. We also argue that these additional functions of corporate governance can emerge unexpectedly for the group. While originally companies implement corporate governance at the subsidiary level to attract capital and to satisfy the demands of the minority shareholders, over time they start using these institutions as a tool of corporate management, i.e., to ensure the internal cohesion of the company and to improve strategy formulation and implementation. In this case, the institutions of formal corporate governance survive even if the original goal of attracting capital becomes less relevant (e.g., because of the changing external environment). There is a very large social science literature highlighting the changes of the functions of institutions without changes in their form (e.g., Voigt 1999).

In particular, we look at the role of boards of directors of subsidiaries in this context. Empowering boards and appointing strong independent directors can play an important role in reducing the concerns of minority shareholders if there is a dominant shareholder directly involved in the company management. The evidence on whether and how the boards of subsidiaries can be used by the group management to improve the quality of decision-making is extremely limited. Sur et al. (2013) argue that in a subsidiary of a business group where the extent of interventions into operational decisions is substantial, the board exercises the service function associated with the resource dependence perspective. The main problem faced by the shareholder is likely to be associated with ensuring connections between different elements of the group; hence, directors will be recruited from other subsidiaries. We attempt to provide an indepth investigation of whether and how boards exercise this function in the context of emerging markets.

We test our argument using the case of a large diversified Russian business group, AFK Sistema. Sistema was among the first in Russia to rigorously introduce formal corporate governance mechanisms at the level of the holding company; it was done to both attract foreign capital and to improve the quality of strategy formation. In particular, Sistema created a strong board with a majority share of independent directors at the holding company level (Libman et al. 2014). However, Sistema also introduced similar corporate governance mechanisms with strong boards in its subsidiaries. This was originally done to facilitate their IPOs, which served as a tool to gain additional capital for their development during the period of economic growth in Russia in 2000–2008. These advantages of the IPOs disappeared with the global economic crisis of 2008. At that time, however, the institutions of corporate governance were not dismantled, but were used as a tool for corporate management, offering new opportunities for improving cohesion within the group—a task particularly challenging for conglomerates.

The paper is organized as follows. The next section develops the theoretical argument. The third section presents the Russian context and the case of Sistema. The fourth section discusses the empirical methodology of our study. The fifth section presents our main findings. The last section concludes.

2. Theory

2.1. The challenge of internal cohesion and the role of boards

The fact that large conglomerates face significant problems in terms of their manageability has been recognized in management studies at least since the 1970s (Good and Luchs 1993). From this point of view, a central question, which emerges in the literature, is whether belonging to a conglomerate can actually produce additional value for individual companies (Goold et al. 1994 refer to it as the 'parenting advantage'). A conglomerate can enhance the performance of its companies only when it provides access to resources unavailable on the open market (Markides and Williamson 1996). In the context of emerging markets, these specific advantages can be linked to poor quality of institutions in the economy in general—business groups offer their companies substitutes for defunct capital and labour markets and contract enforcement mechanisms (Leff 1978; Berglöf and Perotti 1994; Khanna and Palepu 1997; Carney and Gedajlovic 2002; Fisman and Khanna 2004; Peng et al. 2005; He et al. 2013). The value of these advantages decreases if there is a certain incremental improvement of the institutional environment outside the company (as happened in Russia) (Khanna and Palepu

2000; Kim et al. 2004); thus, the question becomes whether the group can offer further long-term gains for its subsidiaries.

A crucial parenting advantage, applicable to both emerging and mature markets, was identified by Prahalad and Hamel (1990). This paper introduced the concept of ‘the core competences of a group’, defined as “the company’s collective knowledge about how to coordinate diverse production skills and technologies”. Core competences go beyond the boundaries of a particular business unit and are related to the process of collective learning and information exchange within a multi-business group. Obviously, these competences cannot be acquired by a stand-alone firm, as they are connected to a particular group (in many cases, representing the tacit knowledge of its managers and employees). However, making sure this collective learning actually functions in a corporation is a non-trivial task: first, managers are frequently incentivized to focus on their business units (e.g., if their bonus payments are connected to the performance of this unit in particular and not of the group as a whole), and second, micro-politics within the organization and power struggles between subsidiaries for resources (Bouquet and Birkinshaw 2008; Becker-Ritterspach and Doerrenbaecher 2009) could make their interaction costly.

The central question becomes how information exchange within the organization can be organized and facilitated. Grant (1996) points out that knowledge in organizations is, ultimately, possessed by individuals and the organization should create mechanisms through which this knowledge is shared and taken into account while making strategic decisions. These mechanisms could include formal rules and regulations which govern the interaction between individuals, but also informal co-operation within groups to solve problems and to exchange knowledge. There have been numerous studies of various mechanisms which can be used to exchange knowledge within an organization, using different theoretical perspectives (Tsai 2001, 2002; van Wijk et al. 2008); the literature also looks at knowledge sharing across the subsidiaries of a business group (here multinational corporations attracted particular attention, see Björkman et al. 2004; Riege 2005; Li 2005; Fey and Furu 2008).

The resource-based literature on boards of directors explicitly points out their ability to contribute to the acquisition of knowledge (Hillman et al. 2009). This function is typically associated with the position of the board’s members in various networks (and the existence of interlocking directorates, i.e., cases when the same individuals hold positions on several boards of different companies), which allow information exchange, and with the tacit knowledge board members possess and put at the disposal of the company. However, the research on the boards of directors typically emphasizes the access to knowledge from the *external* environment of the organization through appointing outsiders as directors. Nevertheless, it is plausible to argue that boards can play a similar role *within* an organization. In a business group with multiple subsidiaries, each with its own board of directors, these boards can provide a convenient platform for the organization of information exchange between different parts of the organization. Boards, by design, meet regularly, have extensive access to information on the functioning of their companies, and decide on crucial issues concerning the company's development. Hence, a board represents a natural framework for the regular discussion and exchange of information concerning the company. To achieve this goal, the group should encourage managers from the parent company and from other subsidiaries to be appointed as members of the boards of subsidiaries. This ensures that managers are informed about the development of other subsidiaries and business segments, and any strategic decision at the subsidiary level is made involving managers from different business segments. Furthermore, it is necessary to ensure that boards function not merely as formal structures, where directors appointed by the group strictly follow the directives of the holding company, but as forums for the discussion and exchange of ideas.

2.2. A hypothetical mechanism of the transformation of boards

While the boards of subsidiaries can become tools of communication within the business group, there is no automatism for this. On the contrary, communication can be organized through pure organizational design (e.g., ad-hoc committees, structuring of subsidiaries into clusters, stronger communication of functional and line management) rather than through a complex institution of powerful boards of subsidiaries. However, and this is the main argument of this paper, boards could hypothetically take over the function of ensuring communication within a group through a process of the unintended transformation of the role of corporate governance, if it is at the disposal of the management searching for instruments to solve the problem we have described.

The mechanism in this case can be described as follows. A diversified business group, at some point, starts searching for additional capital. For emerging economies, the two main sources of capital are international capital markets and government subsidies. Both are associated with certain costs, acquiring capital abroad, in particular, makes it necessary to transform the company's corporate governance to protect investors from principal-principal problems. As long as the prospects of obtaining capital from international markets remain viable and sufficiently attractive, the management will undertake the necessary steps to create formal corporate governance mechanisms for subsidiaries preparing for an IPO, including the empowerment of boards. The extent to which this policy is implemented depends on the particular subsidiary: some of them may be mature enough (and will form strong corporate governance institutions), and some of them are not (and in this case corporate governance institutions will remain weaker).

If the capital market environment remains favourable, subsidiaries will undergo an IPO at some time, which will ensure the group maintain strong corporate governance institutions. In this case, using the boards of subsidiaries to maintain the internal cohesion of the group and to facilitate information exchange appears to be an attractive solution for three reasons. First, it is cost-effective, as the company does not need to create alternative institutions (e.g., ad hoc committees), which would consume the time of management staff in addition to board meetings (which have to be conducted anyway to meet the corporate governance requirements). Second, it reduces the tension between the formal and the informal governance in the group, which exists in most emerging market conglomerates (where formal corporate governance was superimposed on the already existing informal institutions). Third, it provides additional gains from placing independent directors on the boards of subsidiaries, in line with the resource dependence perspective. Independent directors, in this case, do not merely communicate with the company managers of a particular subsidiary, but also engage with other managers from the group, who may also benefit from their advice. In the same way, if the directors employ their connections and their reputation to boost the reputation of the subsidiary, gains can be obtained by other companies of the group as well.

The situation is more complex if the capital market environment changes, for example, as a consequence of a domestic (or global) economic crisis, which makes IPOs unattractive. In this case, there is little reason for the group to maintain the whole set of corporate governance institutions, since they are associated with high costs. These costs are present in any market (and are the main reason why the majority shareholders occasionally go for delisting or squeeze out small shareholders), but they are especially high in emerging markets, where firms with strong formal corporate governance are outliers finding it more difficult to engage in business transactions and more vulnerable to the predatory attacks of the government. Hence, the group can decide to dismantle the corporate governance structure it nurtured during the period of a favourable capital market environment and restore the original informal governance mechanisms.

However, there are three reasons which could encourage the company maintain the existing corporate governance institutions even in an adverse economic situation. First, the company can consider the long-term perspective—informal institutions, which serve many emerging market companies very well, are prone to tension and fail to function in the long run. For example, if the current owner decides to reduce his level of involvement in the business the successor may fail to maintain the existing informal ties in the company. Even if the company does not face these challenges now, the owners may anticipate them appearing in the future. Creating formal governance institutions takes time, and adjusting informal practices to these institutions (particularly making sure that formal governance is perceived as legitimate by the management of the company) is even more difficult (on adjusting informal norms through formal institutional change, see Nickerson and Zenger 2002). Second, creating corporate governance institutions typically requires substantial effort from at least part of the management staff. It is also a tool of empowerment for the groups in the management responsible for the corporate governance. Thus, even if IPO plans are cancelled, these groups in the management are likely to insist on keeping the existing institutions intact and to search for new ways of making them useful for the group. Third, if corporate governance institutions are already established, but the informal coordination within the group is weak, using the formal institutions can be cost-effective since new governance structures do not need to be created. Besides, the group can still use IPOs as a source of financing, if the capital market environment improves; in this case, keeping the formal corporate governance institutions (and finding an alternative application for them for the time being) can also be an attractive solution. Corporate governance also matters for attracting bank financing abroad.

As a result of these three factors, the company can decide to maintain formal corporate governance at the level of the subsidiaries (and, in particular, accept the existence of strong boards), but at the same time assign them the new task of organizing communication between subsidiaries and thus improving the quality of decision-making. The use of boards of directors for this purpose should, in particular, be reflected in two instances: first, the appointment of directors who, in line with our argument, should come from other subsidiaries and from the parent company to ensure the internal cohesion of the group and to provide the necessary advice and expertise, and second, the organization of the functioning of subsidiaries, in particular the discretion directors have in casting their votes and in interacting with the management of subsidiaries. If board members have no discretion, then no real interaction and exchange of ideas in the boards of directors can occur; they function merely as 'rubber stamps' for established corporate strategy. If there is no coordination at all, the risks of the loss of internal cohesion of individual companies of the group increase. In what follows, we look at these two issues to identify the function exercised by boards of subsidiaries of AFK Sistema.

3. Case selection and methodology

3.1. Russian context

Russian business setting is useful for investigating the research question of this paper. In the 1990s, Russia's transition, as of many other emerging markets, resulted in the development of a handful of diversified business groups, controlling a broad array of assets (Guriev and Rachinsky 2005; Estrin et al. 2009). This process paralleled the very poor quality of institutions in the 1990s: the protection of property rights and contract enforcement were very weak; legal control over a company did not ensure access to the cash flow or prevent asset stripping (Woodruff 2000). Most of these business groups were characterized by highly non-transparent property relations and poor corporate governance, substituted by informal power relations. The situation, however, started to change from the late 1990s. After a lengthy period of economic decline Russia entered an era of growth associated primarily with high commodity prices, although it affected various sectors of the Russian economy (e.g., the consumer goods industries). Furthermore, there was some improvement in the institutional environment of Russian business, at least relative to the highly unstable period of the 1990s: the government managed to limit the activity of various 'violent entrepreneurs', i.e., criminal and para-criminal groups actively engaged in property redistribution in the 1990s (Volkov 2002); it implemented a number of important reforms (in particular, in the area of taxation, judiciary and land use) in 2001–2003 (Aslund 2004).

As a result, Russian assets became attractive for foreign investors. Among the companies, which as of 2015 were listed on the London Stock Exchange (LSE), only three companies undertook this decision in the 1990s (Gazprom, Tatneft and Lukoil); in 2005–2007, there were 45 IPOs of the Russian companies (PWC 2014) and Sistema was among the first. The Russian stock market index RTSI skyrocketed throughout the 2000s (see Figure 1), as did the value of Russian depositary receipts on international stock exchanges. Improving the quality of corporate governance in order to attract international investors and partners became an attractive strategy for many companies (e.g., Heinrich 2005) although the extent to which this improvement happened varied. Some companies (including Sistema) implemented the change much more rigorously and systematically than others; many attempted to keep the dualism of formally established corporate governance institutions (which lacked any influence on the real decision-making within the company) and de-facto informal decision-making mechanisms.

In the autumn of 2008, Russia was hit by the global financial crisis. The massive negative consequences of the crisis for the Russian market and economy seem to have not been anticipated by Russian businesses and authorities. There is empirical evidence that Russian companies undertook expensive large-scale projects of business expansion (including international acquisitions) as late as in summer 2008, when the global crisis was already on-going; the Russian finance minister Aleksey Kudrin claimed Russia to be a 'safe haven' during the global crisis (Lyashechenko and Nechyaeva 2008). After an average annual GDP growth rate in 2000–2008 of 7.2% (according to official Russian statistics), in 2009 GDP declined by 7.8%

and the stock market collapsed (see Figure 1), as a result, numerous IPOs were put on hold. During this period numerous companies considered delisting from Russian and international stock markets (also affecting our case study). In 2008 there were only three IPOs of Russian companies on the LSE, followed by 2 in 2009 and 3 in 2010 (PWC 2014).

Fig. 1. RTSI stock market index, 1999-2015

Source: Moscow Stock Exchange

By 2011, Russia had managed to restore economic growth, but the economy remained weak, with close to zero growth rates in early 2013. In 2011–2012 the number of IPOs Russian companies listed on the LSE grew, but remained much lower than in the pre-crisis period: there were only 12 IPOs during this period (less than in 2006 alone). In 2013 only one company decided to list on the LSE (PWC 2014). In 2014 geopolitical changes and a drop in oil prices put the Russian economy into a deep recession, leading to a further wave of delisting decisions, this time also caused by concerns associated with the Western sanctions (Gerashchenko et al. 2014, Bezrukova 2015).

Summing up, the Russian situation provides an opportunity to investigate the role of corporate governance in an environment where originally (in the 2000s) the payoffs for adjusting to the demands of international investors were high, but decreased dramatically after the crisis. We study whether under these conditions the companies which originally decided to implement significant investments in improving their corporate governance decided to return to the original informal management mechanisms, or kept their formal corporate governance structures (including the boards of directors at the subsidiary level), but found a new function for them.

3.2. Boards of directors of Russian companies

According to Russian law, a board of directors has to be created in any joint stock company (*aktsionernoe obshchestvo*) with more than 50 shareholders (otherwise the functions of the board can be delegated to the shareholder meeting) using a two-tier board structure; the share of the management serving on the board of directors may not exceed 25% of the directors (the regulations are provided in the Russian Civil Code and in the Joint Stock Companies Act, valid at the moment of our investigation).[5] If a board of directors has to be established, Russian law assigns it the authority to make decisions on company strategy, and key transactions, including mergers and acquisitions (which could be relevant for subsidiaries during the restructuring of a business group), the internal directives and regulations of the company, dividend payments, and company management. This list, however, is not exclusive as companies can decide to assign additional authority to the board through their articles and other internal regulations.

At the same time, the de-jure status of boards in many cases has little impact on their de-facto influence on decision-making. In many Russian companies, boards play a relatively limited role; if they are created to satisfy the formal criteria, they are typically stripped of any de-facto power in the company and support the management decisions without question. Other Russian companies provide real powers to the boards; there is a substantial literature studying the differences in the organization and the empowerment of the boards of directors and their influence on company performance (Peng et al. 2003; Iwasaki 2008; Muravyev et al. 2014; Dulyak 2013). While the cited literature looks at the functioning of boards of Russian companies, to our knowledge there are no studies of the boards established at the level of subsidiaries in large business groups (which, if they are created in the form of a joint stock company, have to follow the same legal requirements in this respect as described above).[6] It is plausible that in many cases these boards are extremely weak and are created merely to satisfy the legal requirements—establishing formal corporate governance structures is expensive in the Russian context, and while Russian businesses could decide to at least partly implement them at the parent company level, the costs at the subsidiary level could be prohibitive. Our study explores a case where some subsidiaries also had a strong potential to acquire additional capital

[5] In 2014, the reform of the Russian Civil Code resulted in a major change of the joint stock companies regulation. The discussion of this section refers to the law valid at the moment of our investigation, i.e., before the reform.

[6] Frye and Iwasaki (2011) consider a somewhat related topic, looking at boards in state-owned companies (they also look at companies controlled by a single main institutional shareholder – in this case, the Russian Federation). However, the motivation of the government as the main shareholder and of private shareholders of business groups like Sistema is likely to differ substantially, and thus affect the company governance and the role of boards.

through an IPO during the boom phase of the development of the Russian economy, and hence, creating strong corporate governance structures could have been reasonable for the company.

3.3. The company case

In order to investigate the transformation of the function of the subsidiary boards, we need to select an empirical case satisfying the following criteria. First, it should be a company, which already managed to make significant progress in terms of applying formal governance institutions at the level of the parent company. Second, the company should include at least several strong subsidiaries with the potential for independent IPOs. From this point of view, we focus on AFK Sistema, which is one of the largest business groups in Russia (in 2013, it was included in the Fortune 500 list). In 2013, company's assets were US$43.2b, the turnover was US$35.9b). Most large Russian business groups and business groups in emerging markets are controlled by a single dominant shareholder and founder. Sistema is controlled by its founder Vladimir Evtushenkov, who in 2013 held 64% of the shares and was the chairman of the board. The shares of Sistema are listed both in Russia and internationally.

From its beginning, Sistema has been characterized by the broad array of industries it is involved in. Unlike other large Russian companies, its focus has been not on oil and gas, but on high-tech businesses. In particular, the group was among the pioneers in developing the mobile phone service industry in Russia. The key asset of the group is MTS, one of the three largest Russian mobile service providers. MTS was among the first Russian companies to undertake an IPO abroad and belongs to a very small group of Russian businesses listed on the New York Stock Exchange (the IPO was implemented in 2000, i.e., before the IPO of Sistema itself). In 2009–2014, Sistema also controlled Bashneft, one of the largest Russian oil companies (as of 2014, with 17.8m tons of oil extracted, it was the sixth largest in Russia). Bashneft is also a public company (listed only in Russia). With these two businesses Sistema, as opposed to many other Russian companies, has substantial experience of managing subsidiaries listed on both Russian and international stock markets. Further subsidiaries of Sistema are present in various industries, e.g., retail; agriculture; tourism; pharmaceuticals; media; and defence. Over time, the composition of the asset portfolio of Sistema changed, depending on the evolution of the Russian economy and the success or failure of individual companies. By early 2010, Sistema declared its goal to transform into an investment company with a broad industrial portfolio.

Sistema is a forerunner of Russian big business in terms of improving the quality of corporate governance (see Dolgopyatova et al. 2015 on the evolution of the group). In 2002, the company disclosed its ownership structure and identified the key shareholder (which was unusual for Russian businesses at a time when most shareholders were disguised through diverse offshore companies). While preparing its IPO in 2005, numerous steps towards the formalization of the decision-making mechanism were undertaken (internal directives, regulations and codes). A particular feature of Sistema, described in Libman et al. (2014) was that the company developed a very strong board of directors relatively early. It recruited numerous independent directors (which by 2012 were the majority of board members), most of them foreign citizens with very broad expertise, and put substantial effort into making the board of directors a functioning institution.

3.4. Data collection

The paper is a qualitative study based primarily on two types of data. The main source is semi-structured interviews we performed with key managers, members of the board of directors of Sistema holding company and with the owner of Sistema. The interviews focused on examining the role of the boards at both the holding and the subsidiary level. Overall, we conducted ten interviews. The main source of information was interviews with managers: we interviewed those responsible for the corporate governance in the Sistema group, and for individual industrial divisions. As we show in what follows, the role of top managers in the boards of directors of subsidiaries is very important, and it explains why this group was able to provide us with abundant information. The interviews with directors (both independent and non-executive) were helpful as far as they participated in the business of subsidiaries (which was true for some of the directors); furthermore, some directors we interviewed have lengthy experience with the company (exceeding that of current managers) and were able to trace the development of Sistema over time.

All interviews were conducted in Moscow in winter 2013–2014. The interviews were conducted by Russian native speakers in Russian with the Russian members of the managerial team and directors, and in English with the foreign directors. Thus, we were able to avoid the problem of cultural bias, which can occur if a researcher implements her study in a foreign country and which has been identified in the literature for Russia (Voldnes et al. 2014). The timing of the interviews was fortunate: we were able to capture the most recent changes in the corporate governance of Sistema however, the interviews were implemented before the company came into the political spotlight in summer 2014, when the government started its attack aiming to re-nationalize Bashneft;[7] at this moment it would be substantially more difficult for us to

[7] In autumn 2014, Russian law enforcement launched an investigation of privatization of Bashneft (originally owned by the government of the Russian region Bashkortostan). The investigation soon led to charges against the owner of Sistema (which purchased the company after it was privatized), who was put under house arrest. Ultimately, a court decided that the stocks of

obtain access. The interviews not anonymous; and the respondents were very open about the advantages of the governance of subsidiaries in Sistema, and the problems the company faced while implementing them. The full list of interviews and details on how we obtained and processed the data and validated our findings are reported in the companion paper to this study (Libman et al. 2014).

As a secondary source of information, we also undertook archival research. In particular, we collected four types of documents. First, we screened the reports of Sistema and, what is particularly important for this study, of its main subsidiaries, which provided information on the functioning of the boards of directors. Second, we collected the internal regulations of Sistema and its publicly listed subsidiaries concerning their corporate governance. Third, we used public statements and interviews of the managers, directors and the owner of Sistema which discussed the implementation of the corporate governance at the subsidiary level. This information was particularly helpful while studying the differences in the role of directors in different subsidiaries. Fourth, the websites of Sistema and its subsidiaries were screened for information on the members of the boards and their biographies.

4. Corporate governance and corporate management in the Sistema group

4.1. IPOs and de-listings of subsidiaries of Sistema

According to a statement by Evtushenkov in the annual report of 2006, Sistema has "never seen public listings as priority in themselves. Rather, they serve as instrument for gaining access to capital for further development". However, in the first decade of the 2000s, the overall favourable market environment for the Russian business provided substantial opportunities for acquiring capital through IPOs of subsidiaries, which was systematically used by Sistema. As mentioned, the first subsidiary to be listed was the mobile service provider MTS in 2000. In 2006, Sistema conducted IPOs of two further subsidiaries: the fixed-line telecommunications company Comstar-UTS and the real estate company Sistema Hals. According to the Sistema's annual reports, the group was able to raise about US$1b from the first IPO and US$409m from the second. In 2007, Sistema conducted an IPO of Sitronics, its electronic assets subsidiary, raising US$356m. In all three cases, shares were listed on the LSE, and the IPOs followed thorough preparatory work, associated with restructuring the businesses and improving the corporate governance. Comstar-UTS as a separate company was created in May 2004,

Bashneft should be returned to the government; Evtushenkov was freed from house arrest and the investigation has been officially abolished. Sistema was acknowledged a bona fide purchaser of the company.

amalgamating assets of three subsidiaries of Sistema (MTU-Inform, Comstar and Telmos), with the oldest having been established in 1993. Sitronics was established in 1997 to merge the subsidiaries of electronics factories of Sistema in Zelenograd (a suburb of Moscow), but later Sistema consolidated most of its electronics assets within this company (already the 2003 annual report mentions the prospects of an IPO for Sitronics, although on the Russian stock market).

Part of the effort of Sistema to prepare the companies for an IPO was improving their corporate governance. Generally, Sistema restructured the corporate governance of its subsidiaries while preparing for the IPO of Sistema itself, creating a number of regulations and internal directives on this matter. In 2007, Sistema introduced a scoring system for the corporate governance of its subsidiaries. Sistema focused on 'replicating' what had been a successful solution for the parent company level at the subsidiary level. Interviewees clearly state that the corporate governance of the holding company was "cloned" (interview with a board member; all Russian quotes have been translated into English by the authors) at the level of subsidiaries. In particular, the company "cloned" what it had already established at the level of the holding company and what our respondents frequently referred to as the "extended responsibility of the board", in addition to the authority granted to the boards by Russian law, the boards of Sistema and its subsidiaries received further prerogatives:

> *In our company the number of issues decided by the board of directors is 3-4 times larger than stipulated by the law. This is an iron rule, which we enforce in subsidiaries by any means necessary (manager).*

The crisis of 2008 put a stop to the series of successful IPOs of Sistema. Under the new market environment, raising capital through an IPO in the international market became prohibitively difficult. The opposite trend emerged. In 2012, Sistema decided to delist Sitronics from the LSE (the delisting from the Russian market followed a year later). This decision was a consequence of a drop in the market capitalization of the company from US$1.8b (in February 2007) to US$105m (in February 2012). Subsequently, Sistema implemented full restructuring of its electronics assets originally pooled in Sitronics. Comstar-UTS was merged with MTS in 2011, and was delisted from the LSE. Sistema Hals experienced substantial economic problems, forcing Sistema to sell their majority stake in the company to VTB bank for a nominal price of 60 rubles in 2009.

After the partial recovery of the Russian economy, Sistema regained ambitions for future IPOs: the 2012 annual report discusses the medium-term prospects for an IPO of SMM (media) and of Detskiy Mir (retail). In the case of Detskiy Mir, the preparation for the IPO was nearly completed and in February 2014 Sistema applied to the Central Bank of Russia for the necessary permission. However, the geopolitical crisis and the international sanctions against Russia made Sistema postpone this decision; as of the end of 2015, the IPO is still considered a possibility which will depend on the market environment (Shamolin 2015). Furthermore, Sistema also planned to list Bashneft on the LSE in 2014; the IPO was postponed after sanctions were imposed against Russia, and by the end of 2014 Sistema lost control over this asset.

It appears that before the crisis of 2008 Sistema had a strong motivation to improve the corporate governance at the subsidiary level as a tool of attracting capital for possible IPOs. After 2008, however, this strategy did not pay off. Under these conditions, it seems plausible that the company should have reduced its effort to implement functioning corporate governance structures at the subsidiary level. This is, however, not what we observe, based on the information from corporate reports and from the interviews we conducted. On the contrary, all the respondents clearly indicated that the corporate governance structures have been maintained and that, for example, strong boards are being created even in companies which have no immediate IPO prospects. Hence, we study the further functions exercised by the corporate governance institutions at the subsidiary level and, in particular, by strong boards of directors.

4.2. Service and communication functions of boards

Hypothetically, the boards of subsidiaries can be used as tools to monitoring subsidiaries' management by the parent company. As part of the transformation into an investment company, Sistema limited the extent to which group management intervened in the operations of the subsidiaries to the absolute minimum; instead, it focused on strategic decisions concerning the entire group. A director confirmed the respective goal of the group, arguing that Evtushenkov has *"insistently promoted this approach. He even kept us, and the members of the board back, so that we intervene in the smaller issues of direct management as little as possible".* According to Evtushenkov:

> *We do not intervene in management decisions, say, in MTS, we do not know, which decisions are made by the board, we know nothing, except we follow the benchmarks precisely; our impact on management decisions is punctual, purely market-based, and we avoid niggling interventions… Yes, if it [subsidiary] starts to fail for some reason, we may again shift to manual management. But it would be an extraordinary situation, and we would try to avoid similar situations in the future ... we try to avoid repeating mistakes.*

Obviously, this could create a principal-agent problem between the group and its subsidiaries, which would explain why the corporate governance structures were preserved.

However, the interviews reveal that the classical principal-agent problem, while occasionally mentioned *("one can be forced to intervene in the operational activity, or the subsidiary will break away from you. These two risks are very high*"—interview with a board member), it is clearly not central for the managers of Sistema. Instead, almost all the interviewees clearly emphasised the issue of coordination of subsidiaries.

Evtushenkov pointed out that he considers upholding the strategy of the group an absolute priority:

> W*e put an emphasize on strategy…. We need to (a) have a common strategy and (b) to make the strategies of subsidiaries uniform, from the point of view of the global vision.*

The respondents suggested that the management of subsidiaries could *"mentally break away"* from the group (board member); that the subsidiaries should be assisted, because they lack *"intellectual and lobbying potential"* (a manager). Sistema invests a lot of effort in overcoming the problem of the lack of coordination.

As we have argued, this function of the boards of subsidiaries should become evident in two aspects. First, it should be related to the composition of the boards: we should find a large number of directors coming from the management of other subsidiaries or from the parent company. This is indeed what the interviews and the analysis of the corporate documentation reveal. Although independent directors play a prominent role in some of the subsidiaries,[8] the overall share of independent directors at the level of subsidiaries, according to the interviews varies between 20% and 40%. This is much less than at the level of the holding company, where the majority of directors are independent. On the other hand, a large share of the board members indeed are 'representatives of Sistema' in the broad sense, either of the parent company, or of the subsidiaries. Table 1 summarizes the structure of Sistema boards in six key subsidiaries for which information is available. Representatives of Sistema are a relative minority in one company (RTI), in the other five companies they are the largest group of board members. Interestingly, it also applies to the companies, which are listed (Bashneft) or were prepared for listing at the time of the interviews: this could be related to the fact that for these businesses Sistema puts particular emphasis on ensuring their coordination with the overall group strategy.

[8] For example, in the RTI (the defense industry subsidiary), Sistema appointed Evgeny Primakov, one of the most influential Russian politicians and the former prime minister, the chairman of the board; obviously, for a defense company with its close ties to the government this decision was extremely helpful. The board of MTS is chaired by Ron Sommer, former CEO of Deutsche Telekom.

Table 1. Composition of the boards of selected subsidiaries of Sistema, 2013

Company	Number of directors	Independent directors		Representatives of Sistema	
		Number	Share	Number	Share
MTS	9	3	33%	4	44%
Bashneft	11	4	36%	6	55%
Detsky Mir	6	2	33%	3	50%
RTI	7	3	43%	1	14%
Medsi	8	3	38%	3	38%
UNC	7	2	29%	2	29%
SMM	10	1	10%	6	60%

Source: financial reporting of individual companies, company websites.

Moreover, Sistema institutes a system of within-group interlocking directorates: executive and non-executive members of the Sistema board sit on 2–5 boards of subsidiaries and act as chairpersons for 1–2 boards; managers sit on 10–15 boards (in many cases, however, these are boards of smaller subsidiaries with a limited role in the group; a manager typically sits on 5–6 boards or subsidiaries important from the point of view of the group) and act as chairpersons 2–4 boards. This approach ensures that by attending various board meetings a member of the Sistema holding company board or of the management receives information about the specifics of the functioning of various subsidiaries and takes that information into account while making group-level decisions. This is clearly consistent with the theoretical argument of our paper.

The second aspect is the functioning of the boards and, in particular, the discretion of directors representing Sistema in their decision-making. Here, an important innovation was introduced in 2009 (i.e., the first year of the crisis, when, as we hypothesize, the 'unintended' function of using corporate governance as the instrument of corporate management became particularly important). Sistema introduced a new approach to the coordination of the actions of its representatives on the boards of subsidiaries. Ten days before the meeting of the board of a subsidiary, for each issue included in the agenda, the company collects opinions of all the interested actors (in particular, members of the top management of Sistema). Based on these opinions, a protocol is prepared, which is provided to the chairperson of the board of the subsidiary. This protocol is taken into account while decisions at the subsidiary level are made, thus, the members of the board of the subsidiary have full information regarding the position of the holding company and other interested parties of the group concerning the decisions they have to make. This protocol serves as a sort of recommendation to the board of the subsidiary, developed collectively by the interested and involved actors in the group. According to an interview with a manager

There is a large list, formed before each board meeting, and as a rule, the chairperson has this list handy, because it can be useful for him. It contains the opinions of all individuals not on the board, and the opinions of functional managers. What was the reason for the introduction of this procedure? We could not make sure that functional managers (legal, finance, strategy) participate in the functioning of the board of directors. But now functional managers know, what is happening in Bashneft, what is happening in MTS. We solve the task of connecting everybody, and everybody is in the same information space.

However, while the boards are responsible for ensuring coordination within the group, they are still autonomous in making decisions. Occasionally, the Sistema management does not prepare any directives for subsidiaries, and in about 20% of the cases, the boards modify, augment or change the recommendations they have received. The board members of subsidiaries representing Sistema are not bound to vote according to the recommendations of the Sistema management: “we have no directives, but a system of analysis and decision making. Board members are responsible for final decisions” (Drozdov 2011). This is strikingly different from practices typically established in Russian companies, where, for example, directors representing the government in state-owned companies are under obligation to vote in line with the directives they received from government officials, and again consistent with our theoretical argument.

The particular contribution of the boards to the functioning of individual subsidiaries varies, however. It seems to be related to the concept of ‘organizational maturity’, which was repeatedly mentioned in the interviews we conducted. Mostly it referred to the ability of a subsidiary to independently implement its business processes without the operational support of the holding company. Some of the subsidiaries (MTS and Bashneft are the most prominent examples) have certainly reached this level of maturity, but others seem to be relatively far from it, for example, because they were formed only recently (through merger of other assets of Sistema or through acquisitions). These less mature businesses pose a problem for Sistema:

Regarding the less developed companies in terms of organizational maturity… we need to substitute [their mechanisms] with our mechanisms, their procurement with our specialists, their marketing with our specialists, although there are only a few individuals implementing this function by [Sistema holding], since we are not an operational company. Sometimes we need to invest substantial effort in companies just to earn something from them. Now we are in the process of budgeting, it will be completed by December…. There are companies, for which we need to change the entire budget, *determine their strategy, their marketing plan for the next year, their real investment plan, and based on this, their budget (manager of Sistema).*

Thus, an important advantage of the approach used by Sistema is that it can be tailored to the demands of each particular subsidiary, attracting the necessary resources and focusing on particular issues relevant for it through adjusting the functioning of the board and its composition.

Summing up, the boards of Sistema's subsidiaries serve not only as places of information exchange, but also as institutions ensuring that decisions made at the subsidiary level fit within the overall company strategy. However, this is done not by merely ensuring the compliance of the subsidiaries with directives coming from the parent company. Instead, Sistema creates preconditions under which members of the boards at various levels make decisions, being informed and considering the situation in other subsidiaries and at the group level—this ensures the vertical and horizontal coordination of decisions within the group. Corporate governance institutions are used to exercise an important function in the group, for which they, strictly speaking, were not originally designed. However, achieving this is not trivial, as the next section shows.

4.2. Selection and motivation of directors

The central problem the group faces in ensuring the functioning of the boards of subsidiaries is to ensure proper incentives for their members. The problem is that in a large business group like Sistema the principal (i.e., the holding company), whom the members of the boards of subsidiaries have to represent, is 'diluted': basically, a director represents a hierarchy of managers and decision-making institutions, with its internal conflicts, information asymmetry and the contradicting interests of individual actors. In a typical emerging market business group, the problem is solved through multiple direct interventions of the majority shareholder at all levels of decision-making: Sistema, however, attempts to move away from this approach and to cultivate formal corporate governance. The procedure of information aggregation through the protocols prepared for board meetings, described in the previous section, solves the problem to some extent, but the solution is not perfect, especially since board members are not bound by the recommendations they have received.

From this point of view, the selection procedure and the incentives of board members are particularly important. In what follows, we provide a detailed discussion of these challenges to demonstrate the problems a company can face while trying to develop the communicative function of boards. We will look at both independent ('external') directors and the internal directors ('representatives' of other units of Sistema). In terms of the communication function, the latter are particularly important. However, the former also play a significant role. One of the benefits of using boards for communication within a company is that the company can also organize information exchange between internal and external directors providing the former with additional information and knowledge, and improving the quality of their decision-making. The boards then exchange information not only within the group, but also between the group and the external environment, allowing the accumulation of specific information concerning individual subsidiaries and taking it into account while making decisions concerning other subsidiaries and the group as a whole.

The main problem for selecting independent directors is that the pool of potential candidates in Russia is relatively small. While at the level of the holding company, and the two major listed subsidiaries (Bashneft and MTS) recruiting independent directors (including foreigners) is not a problem, for other (non-listed) subsidiaries it is substantially more difficult. In an interview, a manager states:

> *As for subsidiaries, independent directors (according to my subjective assessment) function properly in case of MTS… In other companies, unfortunately, independent directors change too frequently… There are many people, they change, go away, we cannot select them… We motivate them, pay a lot of money, and search for industry experts. But to create the proper motivation for an independent director to work for the company is a very difficult task.*

By 2014, Sistema was dissatisfied with the recruitment procedures it had (mostly functioning through informal contacts). Sistema introduced a new approach, creating an open Register of directors which collects information on possible candidates for the boards of subsidiaries. An individual can nominate herself for the register, sending a CV and additional documents to Sistema. If the candidate is approved by a specialized committee of Sistema, she is included in the Register and considered as a candidate for possible appointment in a subsidiary. The selection of directors from the pool is based on further checks and interviews, as well as approval by the shareholders of a subsidiary. Thus, the company increased its openness towards possibly motivated candidates and enlarged the pool of possible directors. At the time this study was undertaken, it was not yet possible to evaluate this innovation for Sistema, as the first appointments were made in summer 2014. However given that the pool of individuals willing and able to become independent directors and satisfy Sistema's requirements in Russia is generally limited, the Register is a partial solution at best.

More importantly, from the point of view of the communication function of the boards, the problem of selection is also present for the group of directors representing the holding company. While the fact that directors sit on numerous boards of subsidiaries has a number of advantages, there is a number of disadvantages as well: the ability of an individual to diligently exercise her function in numerous boards is limited. To some extent, Sistema makes substantial efforts to deal with this problem. The number of boards of subsidiaries where the members of the boards of Sistema are allowed to accept positions was substantially reduced in early 2010s (from 10–15 to 2–5). Still, managers are members of numerous boards: according to one of the interviews, one can effectively participate in at most 3 – 4 boards, while the number of board seats a manager of Sistema occupies is substantially larger. The solution the company used in the past was to delegate lower-ranking managers (e.g., department heads and below) to the boards of subsidiaries. This approach, however, turned out to be ineffective: lower-ranked officials are typically unable to resist pressure from higher-ranked managers and to show sufficient initiative; as a result, their ability to effectively exercise the monitoring function is limited. If there are several managers of different ranks in a single board, according to the interviews, the higher-ranking manager is likely to dominate the decision-making. Ultimately, Sistema decided not to appoint managers below department heads to the boards of subsidiaries, but the differences in rank and status of the members of a single board still persist.

The system of incentives for directors differs for independent directors and for directors representing Sistema in the subsidiaries. The latter receive no remuneration for their actions, which are interpreted as part of their regular work as managers. For high-level managers, there is an indirect link between the performance of subsidiaries and their salaries through bonus payments which are tied to the performance of a particular company or the portfolio of companies this subsidiary belongs to, however, this link emerges because of the managerial responsibilities for a particular company (or group of companies) and not because of the position on the subsidiary's board. For lower-level managers the link between performance of subsidiaries and their salaries is much weaker, which makes them even less willing to invest substantial effort into their work as board members of subsidiaries, which exacerbates the problems of appointing lower-level managers as directors. Independent directors receive financial remuneration for their work.

Sistema also attempts to improve the intrinsic motivation of directors through encouraging informal exchange of opinion and communication among them (for example, one of the practices "cloned" from the level of the holding company to the level of subsidiaries is an informal dinner organized before the board meeting which is used as a platform for the exchange of opinions; the dinner is attended by the directors and by the management of the subsidiary, who can exchange ideas and suggestions regarding the future development of the company). However, the share of independent directors on the boards of subsidiaries is substantially smaller than in case of the holding company; furthermore, unlike the holding company, where directors have the opportunity to communicate with Evtushenkov himself (who ultimately makes the key decisions), in the subsidiaries directors have no direct access to him, which reduces their de-facto impact on decision making.

Finally, while the appointment policy we have described does seem to create preconditions for strengthening the learning process within organization and thus its core competences, it is also associated with certain costs for the group: in some cases managers develop strong personal ties to a particular subsidiary, and as a result, their decisions become biased. In the worst case, managers may turn into lobbyists for individual subsidiaries. Resolving this trade-off remains a further challenge for Sistema.

5. Conclusion

This paper demonstrates that the corporate governance structures at the level of subsidiaries in a conglomerate can implement an additional important communication function, associated with information exchange, and the transmission of knowledge. By creating a within-group system of interlocking directorates, the group can provide an additional mechanism of information exchange and learning, thus improving the quality of the group's decision-making. Thus, corporate governance can be used as a tool of corporate management. In emerging markets, the transformation of the corporate governance functions happens unintentionally. A favourable capital market environment incentivizes companies to invest in improving their corporate governance to attract capital; as a result, they create a tool which can also be used for other purposes (e.g., information exchange within the company). If the external environment deteriorates, companies can continue using this tool, and thus formal corporate governance need not be dismantled even if the ability of the group to attract capital through the IPOs of its subsidiaries diminishes.

We have demonstrated the applicability of this mechanism, using the case of a large Russian conglomerate, AFK Sistema. Sistema was among the first Russian companies to implement an IPO during the era of economic boom in Russia, consistently attracted capital through the IPOs of subsidiaries. In 2008, however, the Russian economy entered a deep crisis, and the opportunities for new IPOs disappeared, in fact, Sistema delisted two of its subsidiaries and sold the majority stake in another. While preparing for IPOs, Sistema developed a system of corporate governance at the subsidiary level, more advanced than is observed in most Russian companies, including very strong boards of directors. After the global capital markets became less attractive, the group maintained these structures, in spite of the substantial costs and re-focused them to be used as a tool to improve the internal cohesion of the group.

From a normative perspective, our study highlights an important and previously unrecognized benefit of developing formal corporate governance structures, particularly applicable to large business groups, where communication between subsidiaries is difficult. We have also shown the difficulties a company in an emerging market would face while implementing this policy. These are the selection of the directors, and creating incentives for them. Sistema faced substantial difficulties in attracting independent directors to the subsidiaries, forcing it to introduce a new approach—an open Register of the potential directors. There are substantial difficulties with motivating internal directors who are essential for within-group communication. The lack of clear connections between the performance of 'their' subsidiaries and their salaries reduces their willingness to invest substantial effort into their assignment to the board, and emerging informal personal connections between the managers and the subsidiaries, where they are assigned to the boards of directors, may bias the decisions at the group level.

While the payoffs from using the boards of directors within the group as communication devices can be high, implementing the communication function of boards is a difficult and non-trivial task.

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