

Unintended Benefits of Empowering Boards in Conglomerates: A Case Study of AFK Sistema*

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Abstract

The paper investigates the role of corporate governance institutions at the subsidiary level in conglomerates in emerging markets. The literature typically highlights that these institutions are necessary to reassure minority shareholders and thus to attract investors. We show that corporate governance institutions, particularly supervisory boards, can be applied for a different purpose – to organize communication within a group and thus to improve the quality of strategy formulation. Thus, a conglomerate can empower its subsidiary boards even if there is no immediate IPO goal for them. The paper uses a case study of a large Russian business group, AFK Sistema, to explore this mechanism, its advantages and its limitations.

Keywords: Corporate governance, conglomerates, boards of directors, communication function, emerging markets.

JEL codes: G34; P31

1. Introduction

The predominance of informal governance practices in emerging markets is widely acknowledged in the literature (Puffer/McCarthy 2011; Estrin/Prevezer 2011), and it is linked to the poor quality of law and the risk of government predation but also to the high economic volatility and crucial importance of rapid reaction to shocks. At the same time, formal corporate governance institutions are essential for attracting financing on global markets. Large business groups, which are typical for emerging markets (Leff 1978), form a particularly interest-

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ing case from this point of view. These conglomerates can acquire capital on the global markets both at the level of the group as a whole and at the level of individual subsidiaries (through their IPOs). In the latter case, the conglomerate must institute formal corporate governance at the subsidiary level to protect minority shareholders from abuse by managers and by the dominant shareholder (Young 2008). At the same time, subsidiaries must remain part of the overall corporate management structure of the group, with which the formal corporate governance mechanisms can clash.

This paper shows that for emerging markets, conglomerates creating formal corporate governance institutions at the subsidiary level can have an unexpected advantage beyond attracting capital. These institutions can be used to improve the within-group communication and internal cohesion of the group strategy. In particular, we look at the role of boards of directors of the group's subsidiaries in this context.

The literature on boards of directors is very rich. While the agency approach highlights their monitoring function, the resource-dependence approach (Hillman and Dalziel 2003) shows that the independent directors'¹ main contribution is to provide resources – their contacts, reputation and market expertise. Thus, they are able to improve the quality of managerial decisions (Zahra/Filatochev/Wright 2009). A much smaller group of studies looks at the role of boards in subsidiaries. Sur, Lvina and Magnan (2013) suggest that these boards should primarily exercise the service function associated with the resource-dependence perspective, especially by improving the coordination of decision-making within the group. Huse and Rindova (2001), however, show that the contribution of subsidiary boards is perceived differently by different stakeholders, who could affect their formation and development. Strikwerda (2003) calls for greater devolution of power to subsidiary boards in order to ensure faster and more flexible decision-making.

The research on subsidiary boards has paid particular attention to boards of foreign subsidiaries in multinational corporations. Kriger (1988, 1991) highlights two important functions these boards can play: improving the coordination of the parent company and the subsidiaries and improving the understanding of the host country specificity; Leksell and Lindgren (1992) refer to them as the 'external' and 'internal' roles of boards. In the analyses of Kim, Prescott and Kim (2005), Jaussaud and Schaaper (2006) and Costello and Costello (2009), boards are primarily used as tools of control exercised by the parent company. Kiel, Hendry and Nicholson (2006), on the contrary, focus on the ability of local boards to limit the influence of the holding company. Du, Deloof and Jorissen (2011) investigate the functions of subsidiary boards within the frameworks of the agency and resource-dependence theories and suggest that subsidiaries' char-

1 Throughout the paper, 'directors' and 'board members' are used synonymously.

acteristics affect the likelihood of the activation of boards from one of these perspectives. Du, Deloof and Jorissen (2015) identify four main functions of subsidiary boards (control, coordination, strategy formulation and service). Finally, Gillies and Dickinson (1999) and Björkman (1994) suggest that the functions of subsidiary boards are very limited or even purely formalistic, and Luo (2005) argues that active subsidiary boards should be a specificity of companies not wholly owned by the parent firm.

Our paper echoes a number of conclusions from this literature (especially its attention to the ability of subsidiary boards to serve as tools of coordination), but it differs in its focus on an emerging market company – a setting that has not been investigated so far in the extant research. Empirically, we provide an in-depth case study of a large Russian business group, AFK Sistema. Dolgopyatova, Libman, Petrov and Yakovlev (2015) show that Sistema was among the first in Russia to rigorously introduce the formal corporate governance mechanisms at the level of the holding company and that, in particular, the Sistema holding company created a strong supervisory board with a large share of independent members (for a detailed discussion of the supervisory board of Sistema at the holding-company level; see Libman/Dolgopyatova/Yakovlev 2014). However, the group also introduced similar corporate governance mechanisms with a strong position of supervisory boards at the subsidiary level. We show that this was originally done to facilitate the IPOs of these subsidiaries at the global markets, which were particularly attractive during the period of economic growth in Russia in 2000–2008. After the global economic crisis of 2008, although the benefits of IPOs went down, Sistema did not abandon the already established corporate governance structures; rather, it used them as a tool of corporate management, offering new opportunities for improving cohesion within the group.

The remaining part of the paper is organized as follows. The next section develops the theoretical argument. The third section presents the Russian case 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 research on conglomerates has systematically emphasized the importance of information exchange within business groups but also the fact that ensuring that this exchange runs smoothly is an extremely difficult task. The fact that success of any organization relies on internal coordination is hardly disputable: Williamson (1971) explains that the very emergence of a business organization requires the ability to ensure coordination of actors in situations where market coordination would result in suboptimal decisions. For conglomerates, information exchange and coordination are essential for achieving a critical parenting

advantage (Goold/Campbell/Alexander 1994; Markides/Williamson 1996) – the formation of what Prahalad and Hamel (1990) refer to as the “core competence of the group”. According to Prahalad and Hamel, the core competence is defined as “the company’s collective knowledge about how to coordinate diverse production skills and technologies”. The core competence can emerge only through the process of collective learning and information exchange within multi-business groups.

Despite the importance of this collective learning process, it faces many obstacles. The structure of managerial incentives, the limits of information transmission in hierarchies (Prendergast 1993) and the micro-politics and redistribution conflicts between subsidiaries (Becker-Ritterspach/Doerrenbaecher 2009) create frictions in the information exchange. Thus, the company should invest substantial effort in creating mechanisms through which this knowledge is shared and taken into account while making strategic decisions (Grant 1996). These mechanisms could include formal rules and regulations, but also informal routines of co-work within groups. There have been numerous studies on various mechanisms used to exchange knowledge within an organization (Tsai 2001, 2002; van Wijk/Jansen/Lyles 2008); a large body of literature looks at knowledge sharing across subsidiaries of a business group (Björkman/Barner-Rasmussen/Li 2004; Riege 2005; Li 2005; Fey/Furu 2008).

Subsidiary boards could potentially become a tool for information transmission and knowledge sharing. In a business group with multiple companies, each with its own board, these boards can provide a convenient platform for the organization of informational 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 further development. Hence, a board represents a natural framework for regular discussions on improving the coordination of decision-making.

We hypothesize that the use of boards for the purpose of communication should have two main effects. First, it should affect the selection and appointment of directors: the group should encourage managers of the parent company and of other subsidiaries to become board members. In this case, one ensures that managers are informed about the development of other subsidiaries and business segments and that any strategic decision at the subsidiary level is made involving managers from other companies of the group. Second, it should affect the functioning of subsidiary boards – in particular, the discretion directors have in casting their vote and in interacting with subsidiaries’ management. If the board members have no discretion, no real interaction or exchange of ideas in the boards can occur – they function merely as formal ‘rubber stamps’, implementing an already established corporate strategy. In what follows, we look at these

two effects to identify the function exercised by subsidiary boards of our case study company.

2.2. *Unintended transformation of board functions*

While subsidiary boards can become tools of communication within a business group, it is not necessarily the case that the business group management will select this particular tool of communication. Communication can be organized through the organizational design (ad hoc committees, structuring subsidiaries into sub-holdings or regular interaction of functional and line management) rather than through complex and rigid corporate governance institutions. We suggest that the use of boards as communication devices in a business group could in some cases emerge as an unintended outcome of creating corporate governance institutions for the purpose of acquiring capital from the international markets. If, due to an external shock (global recession or an economic crisis in a particular country), this source of financing dries out, the conglomerate could decide not to dismantle the corporate governance institutions at the subsidiary level but rather to re-purpose these institutions, transforming them into a tool of corporate management.

We hypothesize that there are three main reasons for conglomerates to use subsidiary boards for intra-group communication and cohesion, even if the capital market environment changes so that the IPOs become unattractive.

- First, it appears to be cost-effective: the company does not need to create alternative institutions, which would consume further time of the management staff, and utilizes the already established organizational structures. Formal corporate governance requirements could also make the evaluation of performance of subsidiaries more transparent.
- Second, the company could consider the long-term perspective: a purely informal governance structure is unlikely to sustain its development beyond certain threshold (Gedajlovic/Lubatkin/Schulze 2004). Even if, at the current moment in time, informal institutions function smoothly, preparing for an inevitable transition to the formal governance takes a lot of time; hence, introducing it at an early stage could be advantageous (Nickerson/Zenger 2002).
- Third, creating corporate governance institutions typically requires substantial effort from at least part of the management staff. It is also a tool for empowering the groups in management responsible for corporate governance. Thus, even if the IPO plans for subsidiaries are cancelled, these groups in management could attempt to keep the existing institutions intact and to search for new ways of making them useful for the group.

The subsequent analysis aims to show whether we indeed observe this unexpected transformation of boards in a real-life setting.

3. Case selection and methodology

3.1. Russian context

Russian business offers us a fruitful playground for studying the research question of this paper. In the 1990 s, the Russian transition resulted in the development of a handful of powerful business groups (Guriey/Rachinsky 2005), mostly characterized by highly non-transparent property structures and poor corporate governance, substituted by informal power relations (Pappe 2002). In the early 2000 s, after the lengthy period of economic decline, Russia entered an era of growth (Cooper 2008). The institutional environment of the Russian business improved somewhat, at least relative to the highly unstable period of the 1990 s: the government reduced the risks of expropriation of assets by criminal groups (Volkov 2002) and implemented a number of important reforms (Aslund 2004). As a result, Russian assets became attractive for foreign investors. In the 1990 s, only a few companies dared an IPO at the global markets; in 2005–2007, there were 45 IPOs of Russian companies abroad (PWC 2014). Improving the quality of corporate governance to attract foreign capital became an attractive strategy (Heinrich 2005).

In the autumn of 2008, Russia was hit by the global financial crisis (Gaddy/Ickes 2010). After the average annual GDP growth rate of 7% from 2000–2008, in 2009, the GDP declined by 7.8%;² the stock market collapsed,³ and, as a result, most IPO projects were put on hold. Numerous companies considered delisting from the international or Russian stock markets. In 2008, there were only three IPOs of Russian companies in London, followed by two in 2009 and three in 2010 (PWC 2014). By 2011, Russia managed to restore economic growth, but the economy remained weak, with growth rates close to zero in 2013. In 2011–2012, the number of IPOs Russian companies carried out in London grew in comparison with the crisis period but remained much lower than in the pre-crisis era: there were only twelve IPOs during this period (less than in 2006 alone). In 2013, only one company decided to implement an IPO at the London Stock Exchange (LSE) (PWC 2014). In 2014, geopolitical changes and drop in oil prices put the Russian economy into a deep recession, leading to a further wave of delisting decisions, also caused by concerns associated with the Western sanctions (Abramov 2015).⁴

2 Data on the growth rates of Russian GDP from the official statistics are available at http://www.gks.ru/free_doc/new_site/vvp/vvp-god/tab3.htm, accessed 05 December 2016.

3 The dynamics of the Russian stock market are traced using the data from the RTSI index; see <http://moex.com/ru/index/RTSI/>, accessed 05 December 2016.

4 See, for example, newspaper articles, published in Kommersant, 31 July 2014; Kommersant, 24 November 2015.

3.2. Supervisory boards of Russian companies

According to Russian law, any joint stock company (*aktsionernoe obshchestvo*) with more than 50 shareholders is required to establish a supervisory board (typically referred to as ‘board of directors’ (*sovet direktorov*) in Russian) and a management body, which can be represented either by a separate management board or by a unitary CEO. Thus, Russian companies can use both a one-tier and a two-tier board structure. Throughout this paper, we define the board of directors as the supervisory board only and separate it from the management board (see Chernykh 2008; Ferreira/Kirchmaier 2013 for different approaches to singling out boards in Russian companies). The Russian law assigns the supervisory board the authority to make decisions on company strategy, key transactions (including mergers and acquisitions), internal directives and regulations of the company and dividend payments, as well as company management. This list, however, is not exclusive: companies can decide to assign additional authority to the board through their articles and other internal regulations.⁵

At the same time, the de jure status of supervisory boards frequently has little impact on their de facto influence on company decision-making. According to Lazareva, Rachinsky and Stepanov (2008), in many Russian companies, supervisory boards play a limited role; even if they are created to satisfy formal criteria, they are typically stripped of any de facto power in the company and approve management decisions without questions (Dulyak 2013). An important reason for this outcome is the high concentration of ownership: dominant shareholders in Russia are typically directly involved in business activities and have little interest in using supervisory boards as a monitoring instrument (Dolgopyatova 2004). Some companies, however, do create a strong supervisory board (see Dulyak 2013). While a body of literature looks at these features of the boards of Russian companies (Peng/Buck/Filatochev 2003; Iwasaki 2008; Muravyev/Beresinets/Ilina 2014), to our knowledge, there exist no studies on the subsidiary supervisory boards (SSBs) in business groups. Our paper intends to fill this gap.

3.3. The company case

To investigate the transformation of the function of SSBs, we must select an empirical case satisfying the following criteria. First, it should be a group that has 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 of independent IPOs. From this point of view, we have decided to focus on AFK Sistema. Sistema is one of the largest business groups in Russia. In 2013, according to Sistema’s financial reporting, the company’s assets accounted for 43.2 bln USD,

5 The text of the Russian Law on Joint Stock Companies as of 2013 is available here: <https://www.eg-online.ru/document/law/211524/>, accessed 09 December 2016.

and the turnover reached 35.9 bln. USD. The group is controlled by a single dominant shareholder and founder, Vladimir Evtushenkov, who, as it was officially disclosed by the company, by 2013 held 64% of the shares and, according to the interviews we conducted, was actively involved in the day-to-day decision-making.

Unlike other large Russian companies, Sistema's traditional focus has been not on oil and gas but on high-tech businesses (Pappe 2000). The group was among the pioneers in developing the mobile phone service industry in Russia through its subsidiary MTS, which still remains one of the three largest Russian mobile service providers and the key asset of the group (Pau 2011). MTS was among the first Russian companies to undertake an IPO abroad and belongs to a very small group of businesses listed on the New York Stock Exchange (the IPO was carried out in 2000, i.e., before the IPO of Sistema itself; see N.A. 2006). From 2009–2014, Sistema was also in control of Bashneft, one of the largest Russian oil companies.⁶ Bashneft is also a public company (listed only in Russia, however). Further subsidiaries of Sistema are present in about 15 sectors, including retail, agriculture, tourism, pharmaceuticals, media and defence industry. By early 2010, Sistema declared its goal to transform into an investment company with a broad industrial portfolio.⁷

As mentioned in the introduction, Sistema is among the forerunners of Russian big business in terms of improving the quality of corporate governance. A particular feature of Sistema is that the company relatively early developed a very strong supervisory board. As shown in Libman, Dolgopyatova and Yakovlev (2014), the founder of Sistema recruited numerous independent supervisory board members, most of them foreign citizens with a very broad expertise, and put substantial effort into making the supervisory board a functioning institution. Hence, the Sistema case indeed satisfies our requirements for an empirical case study.

3.4. Data collection

This paper is a qualitative study based primarily on two types of data. The main source of information was ten semi-structured interviews we performed with key managers, members of the supervisory board of Sistema, the corporate secretary of Sistema (responsible for the implementation of the corporate governance mechanisms) and the owner of Sistema. The interviews focused on examining the role of supervisory boards at both the holding and subsidiary levels; for this paper, the latter part of the data is relevant. The main source of information

6 On the ranking of Russian oil companies, see, e.g., <http://exoid.ru/rejting-neftnyanyih-kompaniy-rossii-2015/>, accessed 05 December 2016.

7 See the interview of the head of Sistema's management board, Mikhail Shamolin, in Vedomosti, 15 June 2016.

turned out to be three interviews with managers: we interviewed those responsible for corporate governance in the Sistema group as well as for individual industrial divisions. The interviews with five parent company supervisory board members were helpful as they participated in the business of subsidiaries; furthermore, some of the respondents we interviewed had 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 from October 2013–February 2014 and lasted for 60–90 minutes. The interviews were conducted by Russian nationals in Russian with Russian members of the managerial team and of the supervisory board and in English with foreign members of the supervisory board to reduce the cultural bias problem (Welch 2006; Voldnes/Gronhaug/Sogn-Grundvag 2014). The timing of the interviews was fortunate. On the one hand, we were able to capture the most recent changes in the corporate governance of Sistema. On the other hand, the interviews were implemented before the company came into the political spotlight in autumn of 2014, when the government started its attack aiming to re-nationalize Bashneft;⁸ at this moment, most likely, it would be substantially more difficult for us to obtain access. The interviews were non-anonymous; however, the respondents turned out to be very open concerning not only the advantages of the governance of subsidiaries in Sistema but also the problems company faced while implementing them. All interviews were conducted by two researchers, which should increase the reliability of observations and findings. We recorded all interviews for further analysis; the respondents did not object to this procedure.

We managed to successfully obtain access to the high-level decision-makers of one of the leading Russian business groups, which is a unique advantage of our study. Obtaining access is typically identified as a major problem for interview research (Harvey 2010). In our case, the access was obtained through the support of the National Research University Higher School of Economics (HSE), one of the largest Russian research universities in economics and management. Specifically, we approached the company by providing a reference letter written by the academic supervisor of the HSE, Evgeny Yassin, former Russian Minister of Economic Affairs (1994–1997). Based on this letter, the owner of Sistema approved the study and agreed to provide an interview himself.

As a secondary source of information, we also applied archival research and collected four types of documents. First, we screened the reports of Sistema and,

8 In autumn 2014, Russian law enforcement launched an investigation of privatization of Bashneft, which soon led to charges against the owner of Sistema. Ultimately, a court decided that the stocks of Bashneft should be returned to the government, but Sistema was acknowledged a bona fide purchaser of the company, and the owner was freed of charges (see summary at: <https://meduza.io/feature/2016/01/14/kak-rassypalos-delo-evtushenkova-sepochka-sobytyi>, accessed 05 December 2016).

what is particularly important for this study, of its main subsidiaries, which provides information on the functioning of the SSBs. Second, we collected the internal regulations of Sistema and its publicly listed subsidiaries concerning the corporate governance instituted in the company. Third, we used public statements and interviews in which managers, supervisory board members and the owner of Sistema discussed the implementation of the corporate governance at the subsidiary level (particularly in the newspapers *Kommersant* and *Verdomosti* as well as in specialized business magazines). Fourth, the websites of Sistema and its subsidiaries were screened for information on board members and their biographies. We carefully studied all of these sources before conducting the interviews and explicitly referred to them during the interviews (Mikecz 2012). After the interviews were completed, we used secondary information to validate some of the findings and to trace the group's evolution until 2015-2016.

4. Findings

4.1. IPOs and delistings of subsidiaries of Sistema

During the period of Russian economic growth, Sistema actively used the international IPOs of subsidiaries to raise capital. 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: Comstar-UTS (fixed-line telecom) and Sistema Hals (real estate). According to the group's annual reports, the group was able to raise about 1 bln. USD from the first IPO and 409 mln. USD from the second one.⁹ In 2007, Sistema conducted an IPO of Sitronics, its electronics assets subsidiary, and, according to the annual report, raised 356 mln. USD. In all three cases, shares were placed on the LSE, and the IPOs followed thorough preparatory work, which involved restructuring the business and improving the corporate governance of the subsidiaries. Thus, Comstar-UTS as a separate company was created in May 2004, amalgamating assets of three subsidiaries of Sistema (MTU-Inform, Comstar and Telmos), with the oldest being established in 1993. Sitronics was established in 1997 to take over the electronics plants of Sistema in Zelenograd (a suburb of Moscow), but later, Sistema consolidated most of its electronics assets within this company.

Part of the effort of Sistema to prepare the subsidiaries for an IPO was associated with improving their corporate governance. Sistema had already started developing the corporate governance institutions of its subsidiaries while preparing the IPO of Sistema itself. According to the interviews we conducted, while designing the corporate governance of the subsidiaries, Sistema consciously and systematically "cloned" at this level the corporate governance of the holding

9 According to the annual reports of Sistema. The full set of reports can be downloaded from <http://www.sistema.com/investors-shareholders/information-disclosure/annual-reports/>, accessed 05 December 2016.

company (interview with a board member; after one of the interviewers reformulated his response, suggesting that the subsidiary corporate governance is “similar” to that of the parent company, the respondent corrected us: “it is not similar, it is exactly the same”¹⁰). In particular, the company “cloned” what the respondents frequently referred to as an “extended responsibility of the [supervisory] board”: in addition to the authority granted to the boards by Russian law, supervisory boards of Sistema and of its subsidiaries received further prerogatives.¹¹

“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).

In an article published by a manager of Sistema (Drozdov 2011:5), he argues that

“We came to a model where the main tool of managing the subsidiaries is the board of directors. ... All main decisions are made at the level of the boards of subsidiaries. There are some exceptions though. For example, decisions on investments or financial guarantees from the joint stock company AFK Sistema [the parent company] are, of course, made by us.... In companies where we have the controlling interest, we have substantially expanded the jurisdiction of the boards of directors, including even some issues of operational management into it.”

In a further interview, a member of Sistema’s supervisory board states that “we managed to create a corporate governance system where the board is a real institution running the business, regardless of the allocation of votes.”

The fact that the IPOs of subsidiaries during this period became the strategic goal of Sistema is confirmed by both annual reports and statements from management. According to an interview of the head of the management board of Sistema, “Sooner or later, we want to place all our companies on the stock exchange”.¹² Evtushenkov, in an interview in 2006, makes an almost identical statement: “All our business units should sooner or later conduct an IPO. ... We have chosen this direction of development as the strategic one, it would be stupid to go back”.¹³ Sistema’s annual report for 2006, for the first time, explicitly states that “by making an investment in a subsidiary Sistema determines the exit strategy to maximize the profits for its shareholders. These scenarios include selling the share of Sistema in a subsidiary to a strategic investor, initial public offering or integration of the subsidiary in the already existing business unit” (before that, only vague formulations concerning multiple sources of financing were used). The annual report for 2007 is even more explicit: as a stra-

10 All Russian quotes have been translated into English by the authors.

11 Note that in the direct quotes from the interviews, the reference is typically to the “board of directors”: in all cases, the supervisory board is implied.

12 Vedomosti, 27 March 2006.

13 Vedomosti 27 February 2006.

tegic goal, it states that “Sistema performs the IPO of its non-public companies after they reach the trajectory of stable growth”.

The statements of the managers also confirm the link between IPO plans and improvement in corporate governance (including the strengthening of SSBs) during that era. In an article published in 2007, the deputy chair of the Sistema supervisory board states that

“Sistema is a holding group and directs the development of its multiple subsidiaries. The participation of the parent company in the subsidiary management is possible only through the corporate governance mechanisms. Furthermore, many subsidiaries plan an IPO. Such companies as MTS and Comstar have already placed their securities at foreign markets. These factors explain the attention Sistema pays to developing corporate governance in its subsidiaries” (Kopyev 2007:22-23).

The article goes on to describe individual measures implemented for this purpose and explicitly mentions “improving the effectiveness of work of boards of directors”. Similarly, for the lengthy procedure of preparing the IPO of Sistema Hals, one of the key steps was to recruit high-profile independent directors onto the SSB and to create SSB committees.¹⁴

The crisis of 2008, however, put a stop to the sequence of successful IPOs of Sistema. In 2012, Sistema decided to delist Sitronics from the LSE,¹⁵ following a twenty-fold drop in its capitalization since the IPO.¹⁶ Comstar-UTS was merged with MTS in 2011, and, respectively, was also delisted.¹⁷ Sistema Hals experienced substantial economic problems, forcing Sistema to sell the majority stake of this company for a nominal price of 60 roubles in 2009.¹⁸ After the Russian economy recovered partially from the crisis, Sistema regained ambitions for new IPOs: the 2012 annual report discusses the medium-term opportunity for an IPO of SMM (media) and of Detsky Mir (retail). In the case of Detsky Mir, the preparation to the IPO was nearly completed: in February 2014, Sistema applied to the Central Bank of Russia for the necessary permission. However, the economic decline and the adverse geopolitical environment made Sistema cancel this decision.¹⁹ Furthermore, Sistema also planned to implement an IPO of Bashneft at the LSE in 2014; the IPO was, similarly, postponed after the sanctions against Russia were imposed,²⁰ and by the end of 2014, Sistema lost control over this asset.

14 Finansovyi Direktor, 14 May 2007.

15 <http://www.comnews.ru/node/67535>, accessed 05 December 2016.

16 Vedomosti, 28 February 2012.

17 Vedomosti, 24 February 2011.

18 <http://www.interfax.ru/business/73006>, accessed 05 December 2016.

19 <http://www.finanz.ru/novosti/aktsii/gk-detskiy-mir-prinadlezhashchaya-afk-sistema-ne-budet-vykhodit-na-IPO-v-2014-godu-1000348419>, accessed 05 December 2016.

20 <http://mfd.ru/news/view/?id=1904145>, accessed 05 December 2016.

It appears that at least before the crisis of 2008, Sistema had a strong motivation to improve the corporate governance at the subsidiary level as a tool for attracting capital for a possible international IPO. This strategy did not pay off after 2008 and was ultimately abandoned in 2014.²¹ Under these conditions, one could have expected the group to reduce its effort to implement the functioning corporate governance structures at the subsidiary level. This is not what we observe in our data. On the contrary, all respondents clearly indicate that the corporate governance structures were maintained and that, for example, strong SSBs were created even in companies without any immediate IPO prospects. This is also visible in two indicators we suggested in section 2: the composition and the functioning of the SSBs.

4.2. *Communication functions of SSBs*

Composition of the boards: According to the interviews, although independent SSB members play a prominent role in some of the subsidiaries, their overall share is not very high, varying between 20 and 40%. This is much smaller than at the level of the holding company, where the majority of directors are independent. Instead, a large share of the SSB members represent the Sistema group. This approach ensures that by attending various SSB meetings, a member of the Sistema holding company board or of its management receives information about the specifics of the functioning of various subsidiaries and takes it into account while making group-level decisions.

The secondary data we collected confirm the perception of the respondents. Table 1 summarizes the structure of SSBs of key subsidiaries for which the detailed information is available. In particular, we report data for five time periods: 2008 – the last year of high growth of the Russian economy, when (until September, when Russia was hit by the global financial crisis) the IPO remained an attractive option for the company; 2009 – the peak of the global financial crisis; 2012-2013 – recovery from the crisis, when Sistema again considered the possibility of the IPOs; and 2015 – deep crisis after the fall of oil prices and imposition of sanctions. For each year, we report the overall number of SSB members as well as the size of two most important groups – independent directors and representatives of Sistema and other subsidiaries.

Two results stand out. First, the structure of SSBs remains stable: there is no systematic evidence that Sistema reduced the number of SSB members (or even independent directors) in all subsidiaries of the group in 2015, when the prospects of an IPO became less likely. In 2015, for example, Detsky Mir even increased the size of its SSB and kept the same number of independent directors. Second, in all subsidiaries (with the exception of RTI – this subsidiary operates in the de-

21 In 2017, Sistema implemented the IPO of Detsky Mir, but the shares were offered only through the Russian stock exchange and not through international capital markets.

fence industry with a very specific business environment), the majority or at least the largest group of board members are representatives of the Sistema group. Interestingly, it also applies to the companies that were listed (Bashneft and MTS) or were prepared for listing at the moment of our interview: this could be related to the fact that for these businesses, Sistema puts particular emphasis on ensuring their coordination with the overall group strategy.

Table 1: Structure of membership of SSBs of key subsidiaries, end of the year

	2008	2009	2012	2013	2015 ^a
RTI (defence)					
Members of the board	9	9	7	7	7
Independent directors	0	0	2	3	2
Representatives of Sistema	2	1	2	1	2
Detsky Mir (retail)					
Members of the board	7	7	8	6	10
Independent directors	1	1	2	2	2
Representatives of Sistema	5	5	3	3	5
SMM (media)					
Members of the board	9	10	10	10	7
Independent directors	0	1	1	1	0
Representatives of Sistema	8	7	6	6	3
MTS (telecom)					
Members of the board	9	9	9	9	9
Independent directors	3	3	3	3	4
Representatives of Sistema	4	3	4	4	3
Bashneft (oil extraction)					
Members of the board	9	9	10	11	10
Independent directors	0	0	4	4	3
Representatives of Sistema	3	8	4	6	6
Medsj (medical services)					
Members of the board	7	8	8	8	8
Independent directors	0	0	2	3	3
Representatives of Sistema	4	5	3	3	3
UPC (oil refinery)					
Members of the board			7	7	9
Independent directors			2	2	2
Representatives of Sistema			5	2	5

^a For Bashneft – 2014; for UPC – September 2014

Source: corporate reporting of individual companies, company websites.

Both the interviews and the secondary sources indicate that Sistema instituted a system of interlocking directorates, with officials of the parent company holding positions on numerous SSBs. According to the interviews, non-executive mem-

bers of the Sistema supervisory board sit on 2-5 subsidiary boards and act as chairpersons for 1-2 boards; managers sit on 10-15 boards and act as chairpersons of 2-4 boards. To collect the secondary data on this topic, we used the quarterly reports of Sistema²² (we looked at the fourth quarter of 2013, i.e., the period of our study, and the third quarter of 2016, i.e., a period when the likelihood of IPO of subsidiaries became particularly small due to sanctions and economic crises). Quarterly reports list the mandates of Sistema supervisory and management board members; unfortunately, they typically include information only on the most important mandates. Furthermore, the reports include the list of subsidiaries that are controlled by Sistema; this list, again, is not complete (again, only the relatively important subsidiaries are mentioned; subsidiaries of subsidiaries are not mentioned). Nonetheless, we checked all mandates of the board members listed in the reports; if the particular company was not listed in the quarterly report as a Sistema subsidiary, we used all possible available sources (company websites, media reports and SPARK database) to check whether they actually belonged to the group of Sistema. If, in any of these sources, no information linking it to Sistema was found, the mandate on the supervisory board of this company was not counted as one on a Sistema SSB. Based on this approach, we computed a number of indicators characterizing the role of interlocking directorates and reported them in Table 2.

Table 2: SSB mandates and chairmanships of Sistema management and supervisory boards' members

	2013	2016
SSB mandates		
Sistema management board member, average	5.76	5.71
Sistema management board member, largest number of mandates	17	16
Sistema supervisory board member (only non-executive directors), average	1.36	1.63
SSB chairmanships		
Sistema management board member, average	1.23	1.07
Sistema management board member, largest number of chairmanships	4	5
Sistema supervisory board member (only non-executive directors), average	0.73	0.63

Source: Sistema quarterly reports. Mandates of the owner are not counted due to his special status in the company.

Again, there is no evidence that the extent of involvement of Sistema board members in the SSBs goes down significantly after the IPO prospects become grim. Some of the numbers are smaller than those from the interviews because not all subsidiaries are mentioned and because not all companies with mentioned

22 Quarterly reports are available at <http://www.sistema.ru/investoram-i-akcioneram/raskrytie-informacii/ezhekvartalnye-otchety/>, accessed 05 December 2016.

mandates could have identified as subsidiaries of Sistema. Importantly, focusing only on the management board, we under-estimate the presence of the overall Sistema management in the SSBs; in many cases, Sistema seems to send high-level managers below the management board level to subsidiary supervisory boards. In BPGC (electricity transmission), for example, as of 2016, four of nine SSB members represent Sistema management, but only one belongs to the management board; in Intourist (the tourism subsidiary of the group), of four Sistema management representatives in the seven-person SSB, only one is a member of the Sistema management board. This is, in fact, an important problem for the company, which we discuss in the following.

In some cases, when there are clear links between the businesses of individual subsidiaries, Sistema also appoints managers of these subsidiaries to other SSBs. For example, in 2013, of three representatives of the Sistema group in the SSB of the UPC (oil refinery), one came from Bashneft (oil extraction) and two from the holding company. In the MTS Bank SSB, as of 2015, of 10 members, two were independent directors, three came from the Sistema holding group and three from MTS (MTS Bank services transactions of the MTS retail network).²³ In 2016, one of the Sistema representatives in Tekhnopark Sarov SSB, a business incubator created by the company, came from the RTI – a subsidiary directly involved in the implementation of this project.

Functioning of the boards: In our analysis, we focused in particular on the discretion of SSB directors representing Sistema in their decision-making. In 2009 (i.e., the first year of the crisis, when the prospects of IPOs of subsidiaries became less important), Sistema introduced a systematic procedure to coordinate the actions of its representatives in the SSBs. Ten days before an SSB meeting, for each issue included in the agenda, the company collects the opinions of all interested actors (particularly members of the top management of Sistema). Based on these opinions, a protocol is prepared, which is provided to the SSB chairperson. This protocol is taken into account when decisions at the subsidiary level are made; thus, SSB members have full information regarding the position of the holding company and other interested parties of the group concerning the decision they have to make. In some cases, a special meeting of company managers and SSB members is organized to resolve possible differences. According to an interview with a manager:

“There is a large list, which is formed before each meeting of the board of directors, and as a rule, the chairperson has this list handy because it can be useful for him – it contains the opinions of all individuals, who are not on board, 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) participated in the functioning of the board of directors. What can be

23 MTS bank is held directly by Sistema and not indirectly through MTS; the same applied to UPC in 2013. In 2014, the management of UPC explicitly pointed out that the company’s plans are “synchronized” with those of Bashneft (Kommersant, 27 February 2014).

done about it? ... But now functional managers know what is happening in Bashneft, what is happening in MTS. We solve the task of connecting everybody; everybody is in the same information space."

Importantly, the protocol serves as a framework for communication and discussion and not as a mandatory instruction for all boards. The members of the SSBs representing Sistema are not bound to vote according to the recommendations of the Sistema management: according to Drozdov (2011:7), "we have no directives, but a system of analysis and decision making. Board members are responsible for final decisions". He furthermore notes that

"In practice, it happens that members of subsidiary boards vote not in accordance to recommendations. Discussion at the board meeting, arguments of management or of other shareholders can influence the voting outcomes. And even if the overall direction of the decision does not change, there may be many clarifications and additions added to it; the initial draft can experience substantial changes in terms of wording and substance. We think that personal discussion at the board meetings is a very important mechanism of decision-making" (Drozdov 2011:7).

According to the interviews, in about 20% of cases, the boards modify, augment or change the recommendations they have received. Drozdov (2011:7) suggests that

"The experience shows that this mechanism of decision-making is very useful. First, it ensures the informational involvement of all departments of the central [group] management into the activity of the subsidiaries. Each division, each manager has the same amount of information about the situation in the subsidiary. Second, one ensures that the decisions are made in a coordinated fashion."

The importance of the coordination function of the SSBs is further highlighted by the fact that SSB meetings are frequently attended by other managers relevant to the decisions to make. According to Drozdov (2011:7):

"By the way, while discussing decisions at the board of directors of a subsidiary, one can always involve the relevant managers, including those of the central staff of the company, through video-conference calls, regardless of where they are".

Summing up, our observations indeed reveal that the SSBs serve as tools of communication and strategy alignment within the group, ensuring that decisions made at the subsidiary level fit within the overall company strategy. The group creates preconditions under which SSB members at various levels make decisions, are informed and consider the situation in other subsidiaries and at the group level. More generally, the internal cohesion of the group strategy is recognized as one of the key issues for Sistema in almost all interviews we conducted. The group owner, in his interview, argues that "we put an emphasis on strategy, ... We need to a) have a common strategy and b) make the strategies of subsidiaries uniform, from the point of view of a global vision". The respondents suggest that the management of subsidiaries could "mentally break away" from the group (manager) or that the subsidiaries should be assisted because they lack "intellectual and lobbying potential" (supervisory board member). Thus, the in-

stitutions of corporate governance are indeed utilized by the group as a tool of corporate management.

4.3. Control function of the SSBs

Using SSBs in a way Sistema does could potentially create tension between their function as communication devices and that as control of the parent company over subsidiaries. In our interviews, the issue of control, while occasionally mentioned, never seemed to be central for the managers and the major shareholder of Sistema. Most interviews clearly emphasized the issue of coordination and strategy cohesion. In fact, the owner of Sistema, at the very beginning of the interview, without any suggestion from our side, indicated information as the main challenge:

"It is impossible that one man makes all correct decisions, for the simple reason that to make a correct decision, one needs a lot of information, and objective information... Typically, people, managers of all ranks, lack objective information. Sometimes they have wrong, even harmful information, and sometimes there is not enough information."

The issue of control featured prominently only in one interview with a member of the management board; however, the main problem even for this respondent was not the classical one, emphasized by the agency theory (abuse of a power position by lower-ranked managers; this was not mentioned at all) but rather the issue of incompatible ideas of how the group should develop. Thus, according to his interview, in some subsidiaries, "the management is honestly convinced that it ... pushes the company forward, and we disagree with it. But even then, we understand that we have selected the right management staff and, hence, should not intervene in the operating activity but keep all the right and necessary tools of control".

Strictly speaking, the fact that control is probably not the most important objective SSBs have to achieve follows directly from how the governance of Sistema is organized. If Sistema wanted to achieve complete control over subsidiaries, it would (a) never delegate sufficient authorities to them in the first place (i.e., continue making decisions in the group headquarters and structuring incentives for subsidiary managers in way that they fully implement these decisions to the letter) and (b) in case some delegation is inevitable (because there is an external shareholder), give the Sistema representatives in the SSBs clear and unambiguous guidelines as to how they must vote. In fact, in his interview, the owner describes that direct control through informal means is restored if one of the subsidiaries faces larger difficulties:

"Yes, if it [subsidiary] will fail for any reason, we can move back to manually managing it (ручное управление). But it is an emergency, and we will try not to allow something like this because in addition to our successes, we made many mistakes, and we have not forgotten them".

Sistema consistently tries to keep a distance from the operations of the subsidiaries. According to the interviews, the parent company had to focus on strategic decisions concerning the entire group; the founder and key shareholder has “insistently promoted this approach. He even kept us and the members of the board back, so that we intervene into some smaller issues of direct management as little as possible” (director). Furthermore, as mentioned, a high level of autonomy of SSBs is maintained. One could expect control to be achieved through tools other than SSBs – e.g., the system of performance indicators for managers or, if the need arises, direct involvement in subsidiary activity through informal governance mechanisms.

However, the strength of SSBs is not identical across all companies in the group. In the interviews, the Sistema representatives frequently refer to the concept of the *organizational maturity* of subsidiaries. This refers to the factual ability of a subsidiary to independently implement its business processes without operational support from the holding company but also to the presence of a convincing development strategy and the qualifications of management. The less mature businesses pose a problem for Sistema:

“Regarding the less developed companies in terms of organizational maturity... we need to substitute [their mechanisms] by our mechanisms, their procurement – by our specialists, their marketing – by our specialists, although there are only a few individuals implementing this function by us [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 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).

In less mature companies, the control function of the SSB appears to be higher, simply because the management is not autonomous and the most important objective is to make sure it complies with the decisions of the group. Less mature companies are more likely to be governed through informal procedures, as well. “It is illogical to make a board of directors in companies where there are only two people, a technical level of decision-making. There, we mostly have only informal interaction” (manager). If the maturity is higher, management receives more autonomy, and SSBs can concentrate on strategy development, coordination and communication.

4.4. Challenges

The case of Sistema also demonstrates a number of obstacles and challenges the company faces while trying to use the SSBs as a tool of communication within the group. First, while the fact that directors sit on numerous subsidiary boards certainly has a number of advantages, there are also a number of disadvantages: the ability of individuals to diligently exercise their function in numerous boards is limited. According to the interviews, Sistema undertakes substantial effort to

address this problem: thus, the number of SSBs where Sistema board members are allowed to accept positions has been substantially reduced in the early 2010 s. Nonetheless, managers are members of too many boards. One of the respondents claimed that one can effectively participate in at most 3-4 boards, but the number of board seats held by a Sistema manager is substantially larger.

The solution the company used in the past was, as mentioned, to delegate lower-ranking managers (department heads and below) to the SSBs. However, this solution is problematic for another reason. According to an interview with a management board member:

"I tried a lot of times, and my colleagues tried to delegate, but, unfortunately, delegation of people below the department head has never properly functioned. If you have two people with different weight [different position in the corporate hierarchy] in the board – nothing works. If only one heavy-weight goes there, he ... turns out to dictate the decisions."

Ultimately, Sistema decided not to appoint managers below department head positions to the SSBs, but the differences in the rank and status of the members of a single SSB still persist.

A further challenge is to create proper incentives for the SSB members representing Sistema, who, according to the interviews, receive no remuneration for their actions, which are interpreted as part of their regular tasks (as managers). For high-level managers, there is an indirect link between the performance of the subsidiaries and their salaries through bonus payments, which are tied to the performance of a particular company or the group of companies to which this subsidiary belongs:

"Our motivation as managers of AFK is linked to the performance of subsidiaries. You can, if you want, just attend the meetings of their boards and not intervene, but then, do not complain if by the end of the year you will receive a 20% or 30% smaller bonus." (manager)

For lower-level managers, the link between the performance of subsidiaries and their salaries is much weaker, which makes them less willing to invest substantial effort into their work as board members of subsidiaries. According to the same interview we quoted above, "for the department heads, it [the motivation system] does not work. I am tied to the motivation system by 100% and my deputy only by 50%". In the conclusion, the manager emphatically states (in relation to the SSBs): "We don't have enough people. Unfortunately, I cannot delegate!"²⁴ Resolving this problem remains a further challenge for Sistema.

24 Appointing managers as SSB members also creates a further risk for the group: in some cases, managers develop overly strong personal ties to a particular subsidiary, and, as a result, their decisions become biased. In the worst case, managers could turn into lobbyists of individual subsidiaries.

5. Conclusion

The paper aimed to demonstrate that the corporate governance structures at the subsidiary level in a conglomerate can implement an important communication function that ensures informational exchange and transmission of knowledge in the group. By creating a within-group system of interlocking directorates, the group provides a mechanism of information exchange and learning, thus improving the quality of the group's decision-making. *Corporate governance is de facto used as a tool of corporate management.*

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 at the LSE, and during the era of economic boom in Russia, it consistently attracted capital through the IPOs of subsidiaries. In 2008, however, the Russian economy entered into a deep crisis, and the opportunities for new IPOs disappeared – in fact, Sistema was even forced to implement a delisting of two of its subsidiaries and to sell its majority stake in another one. While preparing for the IPOs, Sistema developed a system of corporate governance at the subsidiary level, more advanced than what one observes in most Russian companies – including very strong boards of directors. After the global capital markets became less attractive, however, the group maintained these advanced corporate governance 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.

There are several implications of this study for both research and management practice. For practitioners, it highlights a further benefit of corporate governance, which can be achieved even if the capital market environment for business is not favourable. Especially in large conglomerates, but also in other companies where the number and the complexity of ties between subsidiaries make communication difficult, SSBs could become an effective tool for overcoming this problem and thus for improving the performance of the company. However, there are two important challenges the group must resolve in this case. First, the management of subsidiaries should be capable of sufficiently autonomous decision making (organizational maturity): Sistema achieved it for some of the companies in the group. Second (as of now, Sistema has only partially resolved this challenge), one needs to generate a sufficiently large pool of SSB candidates and provide incentives for managers delegated to SSBs.

There are several directions for further research that can be derived from this paper. First, while we focused on a single case study to reveal a previously unexplored function of SSBs, a further important contribution would be to concentrate on comparative research. On the one hand, it could provide insight regarding the relative costs and benefits of SSBs vs. other possible communication tools (ad hoc committees). On the other hand, it could indicate the conditions

under which SSBs can actually be used for communication. For instance, should SSBs be as useful for coordination in vertically integrated companies (another important group of business groups in emerging markets and in Russia; see Pappe/Galukhina 2009) as in conglomerates? Which models of corporate governance (e.g., one-tier or two-tier boards) could be more applicable for using the boards as communication devices? Furthermore, the investigation of the particular micropolitical process leading to the empowerment of SSBs appears to be a very interesting direction of research, although obtaining information on it would be difficult for any case study company.

Finally, the focus on a single case study requires us to discuss the problem of generalization of our results. The logic described in this paper, hypothetically, could be applicable for a variety of companies facing the problem of information transmission within subsidiaries. There are, however, two important constraints. First, size matters – not only for the importance of information transmission problems but also for the practicality of using SSBs to resolve it (even companies smaller than Sistema with a weaker reputation could find out that they are unable to form a sufficiently large pool of candidates for SSBs). Second, a certain level of development of corporate governance law and, in general, adherence to the rule of law is required. Russia in the 2010 s is clearly problematic in this respect, but there are numerous emerging markets where the problem is much more severe (as it was in Russia in the 1990 s, for example, where *de jure* ownership did not guarantee any control over a company; see Woodruff 2000). In this case, even limited autonomy granted to subsidiary management is very risky for the group; the focus must be on control and not on communication. A more detailed investigation of these limits to the generalization of our findings also offers an important direction for future studies.

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