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INVESTING IN INSIDER-DOMINATED FIRMS A STUDY OF RUSSIAN VOUCHER PRIVATIZATION FUNDS

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Abstract

The paper is based on a survey of 148 Russian privatization investment funds (PIFs) representing, in terms of size, 69 percent of the population of all PIFs created in connection with the voucher privatization of ca.14,000 state enterprises. The PIFs surveyed hold shares in some 4 to 5 thousand privatized enterprises, thus providing a window into the world of corporate governance of a substantial portion of Russian firms.

The paper argues that PIFs, like most other outside investors, have relatively small impact on the governance of Russian firms due to the firms' domination by corporate insiders, particularly management. Given high returns from shareholder activism, the PIFs attempt to influence the firms in their portfolios in a variety of ways (through obtaining board seats and providing them with a range of services), but have extremely poor access to information and are largely unable to prod the firms toward more radical restructuring. In particular, the PIFs are only rarely able to effect managerial changes, although a logistic equation model used shows that firms which do participate in more than one dismissal of top managerial personnel seem to be interested in fundamental restructuring.

The paper also describes the main features of the emerging capital market and presents an econometric analysis of the determinants of the trading activity of the PIFs.

I. The environment

1. Design and evolution in mass privatization

Mass privatization plans, of necessity, contain an important element of design. Their main goal, in addition to removing the state from direct control over enterprises, is to inject a critical mass of assets into the private sector and to change the configuration of the political and economic forces in the country. They are conceived as a result of a conviction that the more traditional ways of privatization are not only too slow, but also ineffective in dislodging the existing interest groups, opposed to an effective change in the way things are run. Unless a large number of firms undergo simultaneous transformation, the plans assume, the old ways of doing things will persist, and even the new private sector might be corrupted by operating in an environment in which rent seeking and soft budget constraints predominate. As such, mass privatization plans, at least in their initial stages, do not rely on gradual, marginal changes in the *status quo*, but attempt to effect a global transformation of the economic and political environment, so as to alter fundamentally the incentive structure of the main actors, and to weaken the relative position of the interest groups opposed to reforms.

But in doing this, the plans must take into consideration two extremely important factors. First, the difference between old style planning and the design of the reform programs is that the latter must always be mindful of the limitations of foresight -- the uncertainties of the future make it certain that serious corrections in the original design will have to occur before the system stabilizes into a working economic order. Second, the plans do not operate in a vacuum. Although they attempt to change the balance of political and economic power, they must rely on some existing interests in order to push through the changes they propose. It may sound like a paradox -- the plans must root themselves in the *status quo* in order to change it -- but the proposition merely reflects a fundamental political reality. This means that compromises have to be made, and the challenge is to make it more likely that their cost will not be, in the long run, too great.

Both of these factors mean that the stage of design in the reform program must assume a process of evolutionary development in the next stage. The design stage may be compared to an activist constitutional period, in which new rules of the game are made and new incentive structures are created. But the design must not over determine the process. It must rather operate on the assumption that its main function is to make sure that the incentives created by the design will make it more likely that further evolution will proceed in the direction of greater openness, rather than ossify into a new suboptimal equilibrium. In other words, although the system created by the design cannot be perfect -- and the necessity of initial compromises makes this even more obvious -- it should be capable of *self-correction* in the future.[5]

2. The specifics of Russian design: insider domination

The dynamics and the uncertainties of the Russian voucher privatization program reflect this logic of the reform process. In order to be able to effect their far-reaching transformative objectives, the architects of the Russian program had to assure that the program had the support of some sufficiently powerful political and economic forces within

[5] Chapter 3 in Frydman and Rapaczynski (1994).

the old system. The program had to have some losers and some winners, and the winners could not be all in the future. But the program also attempted to make it more likely that the structure it put in place would then evolve in such a way as to mitigate some of the dangers implicit in the initial compromises.

The main losers in the Russian privatization program were to be the old centralized industrial structures: branch ministries, industrial associations, trusts, and other lobbies for the *status quo*. The main winners, the forces with which the reformers allied themselves in the great push for quick privatization, were to be the managers and the workers of individual state enterprises, provided they broke away from the old structures. The oft-described privatization program thus essentially gave to enterprise insiders majority ownership of the overwhelming mass of former state enterprises, with the managers owning, on the average, 9 percent of the shares, and the workers owning some 56 percent.[6]

The reformers' assumption behind these moves was, presumably, that the overwhelming insider-domination of the privatized firms would not be desirable in the long run, but that the interests of the local insiders would be less monolithic than those of the old industrial lobby, and that the resulting new ownership structure would be subject to gradual change. The main hopes for change were apparently placed in the workers, who were expected to sell their shares rather quickly in order to cash in on the huge premiums resulting from the mass giveaway, thus allowing for a gradual concentration of ownership in the hands of the managers and new outside owners. The ownership structure that would

[6] Blasi and Shleifer (1995). Their evidence (as of December 1993) is based on data from 142 companies in 32 regions. For a detailed description of the Russian program see Frydman, Rapaczynski, Earle, *et al.* (1993).

result from secondary-market transactions would, in turn, assure (1) that the managers, at least those whose enterprises were economically viable, could be weaned from reliance on state subsidies and that their incentive structure could be tied more closely to the economic success of their enterprises, and (2) that outside owners, including foreign investors, would provide a degree of monitoring and supervision necessary to prevent managerial shirking and opportunism, as well as open the enterprises to the influx of new capital and expertise. This direction of development of the viable enterprises would further weaken the insiders in charge of the white elephants, who would have less chance of succeeding in their demands for continuing subsidies, and be forced to retrench and eventually close down their value-subtracting firms.

3. Is the system evolving toward openness?

Even at this early date, we may say with confidence that the Russian design was very successful in effecting a huge ownership transformation of the Russian industry. We can also state that the most successful of its elements was the gamble on the insiders, who helped to put the program through, despite the immense size of the country and the number of firms involved, with a speed that is quite unprecedented in the postcommunist world. Between January 1992 and the end of June 1994, ca. 14,000 companies were privatized through a combination of insider buyouts and voucher auctions, with an average of 18 percent of each company's shared offered to the public.[7]

[7] Boycko, Shleifer and Vishny (1995) cite 15,779 as the number of voucher auctions at which shares of privatized companies were sold, and estimate the total number of privatized companies at ca. 14,000. As the authors point out, the number of voucher auctions is not a precise indication of how many companies were privatized, because the shares of many companies were offered at two or more

As to whether the design of the Russian program will be anywhere near as successful in initiating an evolutionary process toward greater openness of the Russian ownership and governance structure, it is clearly too early to judge. The program did bring out a very high degree of popular participation: by July 1994, 132.7 mln Russians made some use of their vouchers (even if only to sell them on the open market), and this number represents 87.8 percent of the 151 mln voucher recipients. The program also involved the participation of many institutional actors, prime among them privatization investment funds, new private and privatized companies which acquired shares directly or through intermediaries, and a number of so-called "social organizations."

But so far the evidence does not show any significant lessening of the insider domination of the Russian firms. Indeed, our survey indicates that, as of June 1994, insiders still held majority stakes in ca. 70 percent of the companies in which voucher funds were invested, and this number is not likely to have been significantly higher at any prior time. To begin with, 27 percent of companies going through voucher privatization chose the so-called Variant I or III, which did not give the insiders control over their firms.[8] Further, even in some Variant II firms, in which the insiders could buy 51 percent of their company's shares at bargain basement prices, if the firm was large enough, the insiders did not have sufficient funds to exercise all their rights. And finally, the universe of companies in which the voucher funds have invested is likely to be somewhat less insider-dominated than the whole population of Russian firms, since some (maybe even most) voucher funds may have

separate voucher auctions.

[8] For figures concerning the choice among the three available variants, see Boycko, Shleifer, and Vishny (1995), ch.5.

a preference for non-insider-dominated firms, and there must be some fully (or nearly fully) insider-owned firms, from which all outside owner (and *a fortiori* the voucher funds) are absent.[9]

Although it is too soon to judge how lasting the phenomenon of insider domination will be, there can be no doubt that much of the future of Russian economic order depends on the answer to this question. Indeed, insider control is, for the time being, the feature that pervades the behavior of all actors on the Russian corporate governance scene and limits any influence that outside owners can have on the behavior of Russian firms. This in turn probably restricts the degree of restructuring that can take place in these firms and increases the severity of the agency problems endemic in the postcommunist environment.[10] The purpose of this paper is to examine this issue by focusing on the behavior of the most important outsider owners of the Russian companies -- the so-called Russian privatization funds -- and the influence that insider domination might have on their behavior.

II. Who are the funds?

Any mass distribution of state-owned assets to a large number of recipients must consider some ways of mitigating the problems inherent in dispersed ownership. After all, privatization is supposed to be not just a transfer of title; its primary objective, besides removing the state from direct control over enterprises, is to reduce the agency problems

[9] On the basis of a different sample, Blasi and Shleifer (1994) reports that insiders were majority owners in 65 percent of all Russian companies (median 60 per cent) by the end of 1993. As compared with out (much larger) sample, their figures appear somewhat low.

[10] Chapter 5 in Frydman and Rapaczynski (1994).

generated by modern separation of ownership from managerial control. Too great a dispersion of ownership creates formidable collective action problems that prevent the new owners from monitoring the management, thus defeating one of the main purposes of the privatization program.

Moreover, to the extent that a mass giveaway of state assets does not assign to each recipient a specific security, but provides him with some form of artificial capital (vouchers), which the recipient can then choose to invest in any of the privatized companies, the program must reckon with the information costs and the nondiversification of risk facing the multitude of small investors. The voucher capital distributed to each recipient is too small to warrant a serious amount of investigation concerning available investment opportunities. It is also not big enough to allow for a proper level of diversification.

Mass privatization programs contain a number of devices designed to overcome these difficulties. Among the most important of them, indeed the most important, is the institution of privatization intermediaries, i.e. legal entities the shares of which are owned by the beneficiaries of the giveaway scheme, but which in turn legally own the shares of the privatized companies. The intermediaries, insofar as they function as mutual funds, solve the informational problems of small investors as well as allow them to acquire a share in a diversified portfolio of privatized companies (and perhaps some other assets). To the extent the intermediaries are not merely oriented toward trading, but also engage in active supervision of the companies in their portfolios, they help solve the collective action problems facing the millions of dispersed owners. How the intermediaries are able to fulfill these functions is among the main design issues in any mass privatization.

1. The legal framework

A distinctive feature of the Russian privatization funds has been the ease of entry and the relative laxity of prudential regulation of their activities.[11] Although certain state and state-controlled institutions could not be involved in their creation, any other party could be a founder, and the minimum charter capital was set at the entirely insignificant level of 500,000 rubles -- even in October 1992 (when the law was passed), this amounted to a mere 1,200 US dollars (it was less than 500 dollars in 1993). Even more significantly, there were no financial qualifications at all for persons holding management contracts with the funds; indeed, the fund managers can be, and most frequently are, individuals, rather than companies.[12] The extremely modest financial requirements may have encouraged the formation of truly private funds in an environment in which most established institutions had old links to the state, but, together with the provisions allowing for incentive compensation, they may have also skewed the fund managers' incentives toward very risky investments.

The funds and the managers have to be licensed, but the licenses were apparently issued to any candidate who applied, provided a few statutory conditions were met. The funds must also operate as open joint stock companies, which means that their shareholders have all the voting rights necessary to make changes in the structure of the funds, and the law restricts the security of the manager's tenure by limiting any severance provisions to one

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[11] The voucher funds have been regulated by Presidential Decree No. 1186 of 7 October 1992, "On the Means for the Organization of a Securities Market in the Process of Privatizing State and Municipal Enterprises" ("Voucher Statute").

[12] Of 538 licensed managers, 346 were individuals, and 192 legal entities (data from the Voucher Fund Monitoring Group in Moscow).

half of the yearly management fee.[13] So far these provisions do not seem to have had any effect, but the open-joint-stock-company form leaves open the possibility of future takeovers and other struggles for control. The company form of the funds also means that they are essentially closed-end funds (and do not have to redeem their shares),[14] but the voucher statute also *prohibits* the funds from buying back their shares.[15]

Voucher funds could issue their shares in exchange for vouchers received by the citizens, but they were also authorized to issue them for cash. Given that voucher funds were likely to be cash poor and could not, by law, issue debt securities, the ability to sell shares for cash was potentially important, but at the same time it raised, especially under Russian conditions, the specter of a dilution of holdings of the widely dispersed and passive public shareholders.[16] The funds were also permitted to trade in vouchers (as well as any other securities), and a large portion of their initial activities was, reportedly, in voucher trading. Indeed, vouchers became the first liquid security on the Russian market, and their prices fluctuated widely, both in nominal and real terms.

Given the Czech experience, voucher funds must have been originally seen as threatening to the insiders of Russian enterprises, who were eager to assert their control

[13] The fee itself may, according to the law, be very high: up to 10 percent of the fund's assets per year. Voucher Statute, Art. 34.

[14] The closed-end nature of the funds, which is simply a necessity in the conditions of limited liquidity in the Russian securities markets, is confirmed explicitly by section 9 of the Voucher Statute.

[15] It is not clear whether that was meant as a precaution against selective payouts to favored shareholders or to discourage the funds from making promises of high returns similar to those made by the Czech funds. (Another provision of the statute, section 26, bars the Czech-style advertisement of promises of returns on investment.)

[16] Voucher funds cannot issue debt securities.

over the privatized firms and upon whom the architects of the privatization program relied as their main allies. The original regulations seem to have reflected these fears and a desire to promote the role of the funds as passive traders of securities rather than as active participants in corporate governance, since they limited the funds and their "affiliates"[17] to acquiring no more than 10 percent of the securities of any one issuer. This limitation was never enforced, and the funds often exceeded the allowed maximum. Some of these cases may have been unintentional, since the design of the voucher auctions made it impossible to know *ex ante* how many shares each bidder would ultimately receive, but the funds also acquired larger stakes intentionally, sometimes "parking" them with related entities that did not qualify as affiliates, and sometimes making purchases through additional entities set up by the fund managers.[18]

By the end of 1993, it became clear that the managers of Russian enterprises were firmly in control of their firms, and that strengthening the power of outside owners was an important objective of post-privatization policies. Accordingly, the Privatization Program for raised to 25 percent the limit of any company's shares that may be owned by a single fund and included other regulations in support of outside shareholders.[19]

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[17] Defined as entities owning more than 25 percent of the fund. The funds could not own other voucher or non-voucher investment funds.

[18] Interviews with fund managers in an unpublished pilot study conducted in January 1994. Of the funds in the present survey, 76 own stakes between 20 and 25 percent; 27 between 25 and 50 percent, and four own some stakes of over 50 percent.

[19] Section 9 of the 1994 Privatization Program. The other regulations included a limitation of insider membership on the Board of Directors to one third of the total and a requirement that cumulative voting be used in electing company boards. GKI Regulation No. 44-r of January 10, 1994, "On the Procedure for Approval or Reorganizing Voucher Investment Funds," also provides a legal basis for future mergers of voucher funds (subject to GKI's approval).

2. How big are they?

By the end of voucher privatization, in 1994, there were over 650 licensed funds, but only 516 were at least minimally active -- they responded to telephone calls by a group set up in Moscow to monitor their activities.[20] Voucher funds have been established throughout the Russian Federation, but particularly high concentrations are found in Moscow (62), Sverdlovsk (16), St. Petersburg (13), and Samara (13).

The voucher funds collected over 34 million vouchers, amounting to 23.2 percent of the total distributed to Russian citizens. (See Table 1, below.) While this proportion is not as large as that collected by their Czech counterparts (71.8 per cent), it is nevertheless extremely impressive under Russian conditions. To begin with, many Russian citizens used their vouchers (and probably some more, which they purchased on the secondary market) -- 38.5 million or over 25 percent of the total -- at close subscriptions during which the insiders could acquire the shares of their enterprises at enormous discounts. The same insiders also tried to solidify their control by purchasing their firms' shares during voucher auctions, often using enterprise funds for this purpose, and thus provided additional competition to the voucher funds (indeed, the very tradeability of vouchers, which distinguished the Russian program from the Czech, imposed on the funds a situation in which they had to compete for vouchers with other groups of potential buyers). Furthermore, the Russian funds could not legally advertise promises of spectacular returns to the citizens whom they wanted to persuade to exchange their vouchers for the shares of the funds -- something that was instrumental to the success rate of the Czech funds. Finally, the Russian funds, unlike the

[20] Information obtained from the Voucher Fund Monitoring Group, Moscow.

Czech ones, had no connections to huge state banks, with branches across the country, recognizable household names, and long-standing reputations. Thus, the pay-off for preventing the old structures from getting (at least openly) involved in the creation and management of the voucher funds, was a diminished role for the funds; a price that may well have been worth paying, but which has implications for the role of these financial intermediaries.

TABLE 1

ACCUMULATION AND INVESTMENT OF VOUCHERS BY VOUCHER FUNDS

(as of mid-May 1994)

	NUMBER	PERCENTAGE
TOTAL DISTRIBUTED	151 million	100
SUBMITTED AT CLOSED SUBSCRIPTION	38.5 million	25.5
SUBMITTED AT VOUCHER AUCTIONS	94.2 million	62.4
COLLECTED BY VOUCHER FUNDS	34.74 million	23.2
INVESTED BY VOUCHER FUNDS	29.81 million	19.73

Source: Kommersant, July 12, 1994, and authors' calculations based on the data base of the Voucher Fund Monitoring Group, Moscow, corrected by more recent data from the survey.

Where the Russian funds are truly small, as compared to the Czech ones, is in the size of their share (rather than voucher) portfolio, since they purchased shares of the privatized companies primarily at voucher auctions organized by regional property funds, where prices, while generally low, were considerably higher than at the closed subscriptions for insiders (where the price equaled 1.7 of book value unadjusted for inflation).[21] As a result, the voucher funds, having invested nearly 20 percent of all the vouchers distributed to Russian citizens, managed to obtained only 5.7 percent of the shares of the privatized enterprises.[22] This makes them into not insignificant, but still relatively minor players on the Russian ownership scene, even though they are probably the most important private actors among the outside private owners of Russian firms.

Evidently to prevent the creation of very large individual funds, such as those which arose in Czechoslovakia during the first wave of mass privatization, an upper ceiling of five percent of the total number of vouchers was put on the size of any single fund. No Russian fund even approached this number, with the largest, First Voucher Fund, collecting 2.6 percent of all vouchers. Nevertheless, the concentration of ownership among the funds is quite high, with the five largest funds in our sample having collected 26.57 percent of the vouchers collected by all the funds and 6.11 percent of the total number of vouchers distributed to the population (Table 2, below). The largest of the funds are thus likely to be the major, perhaps dominant, players among the outside owners and may significantly influence the future dynamics of Russian corporate governance and financial intermediation.

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[21] For a few examples of how low these prices were, see Frydman, Rapaczynski, Earle, *et al.* (1993).

[22] This figure is obtained by multiplying the average proportion of the shares of the privatized companies sold at voucher auctions (18 per cent) by the proportion of vouchers spent by the funds at these auctions (31.64 per cent).

TABLE 2

CONCENTRATION OF OWNERSHIP AMONG VOUCHER INVESTMENT FUNDS

TOP NUMBER OF FUNDS	NUMBER OF VOUCHERS COLLECTED (in millions)	AS % VOUCHERS COLLECTED BY ALL FUNDS[1]	AS % OF VOUCHERS DISTRIBUTED[2]
5	9.23	26.57	6.11
10	11.49	33.06	7.61
20	14.56	41.92	9.64
30	16.37	47.11	10.84
40	17.49	50.34	11.58
50	18.25	52.55	12.09

[1] Percentage of 34.74 million vouchers
[2] Percentage of 151 million vouchers

Source: Survey data, authors' calculations based on the data base of the Voucher Fund Monitoring Group, Moscow, and data published in Kommersant, July 12, 1994.[23]

3. The sample

Of the population of 516 voucher funds, our survey includes 148 funds, or over a quarter of all funds in operation. In an attempt to reach a better understanding of the overall impact of the funds, the selection was weighted heavily in favor of the larger funds, with nearly all of the top funds included in the sample. (Table 3 breaks down the population and the sample by fund size, showing the weight of the larger funds in both groups.) As a

[23] Since the data base of the Voucher Fund Monitoring Group of May 1994 in fact contains many entries dating back to September 1993, we have used the data from the fifty largest funds in our survey, which includes nearly all of the largest funds (see below). The inclusion of any large funds missing from our survey would show an even greater concentration of ownership.

result, in terms of the number of vouchers collected, our sample represents up to 69 percent of the total population.

TABLE 3

POPULATION AND SAMPLE OF VOUCHER INVESTMENT FUNDS

(broken down by fund size)

	NUMBER OF FUNDS	
NUMBER OF VOUCHERS	POPULATION	SAMPLE
OVER 1 MILLION	2 (.4%)	3 (2.02%)[1]
500,000 TO 1 MILLION	3 (.58%)	4 (2.7%)
100,000 TO 500,000	35 (6.78%)	33 (22.3%)
50,000 TO 99,999	47 (9%)	23 (15.54%)
10,000 TO 49,999	135 (26%)	60 (40.54%)
1 TO 10,000	233 (45%)	19 (12.84%)
0[2]	61 (11.82%)	0
MISSING DATA	0	6(4.06%)
TOTAL	**516**	**148**

Source: The survey and authors' calculations based on the data base of the Voucher Fund Monitoring Group, Moscow.

[1] The number of funds of this size in our sample exceeds the number in the population, as reported in column 2. This is probably due to the fact that the sample data are from June/July 1994, while the population data are partly drawn from the May 1994 database of the Voucher Fund Monitoring Group (and a high portion of this data had been collected over the six months preceding that date). Generally, the same funds report somewhat higher numbers of vouchers in our survey than in the earlier Monitoring Group's study, possibly indicating significant acquisitions in the intervening period.

[2] Some registered funds did not make any voucher investments.

Funds were interviewed in 28 different regions, with an over representation of regions with a high concentration of large funds. As a result, 40 funds were interviewed in Moscow, 13 in Sverdlovsk, 7 in Krasnodar and Samara, 6 in Perm and Omsk, and less than 6 in each of the other regions. The funds surveyed are divided almost equally (50.7 vs. 49.3 per cent) between those that invest nationwide and those that invest only regionally. On the whole, regional funds in the sample tend to be smaller, having invested an average of 82,500 vouchers, while the nationwide funds show an average of 183,000 vouchers invested.

4. The portfolios

Because of potential overlaps, it is impossible to calculate the exact number of companies in the total portfolio of all the funds in our sample.[24] Ignoring the possibility of overlaps, the funds in the survey report that they are invested in 6,961 non-financial companies.[25] Given their average weighted stake (see Table 6, below) and the fact that the funds in the sample have invested ca. 70 percent of vouchers invested by all voucher privatization funds in Russia, we can say with a high degree of confidence that the funds in our sample own some stake in more than 4,000 (and perhaps even more than 5,000) companies, i.e. more that 27 (perhaps more than 33) percent of the total which went through voucher privatization.[26] Thus, in addition to giving a detailed account of the

[24] We asked each fund in how many companies it was invested, but we do not know how many companies have more than one fund among their owners, nor can we say, with respect to companies that have more than one fund among their owners, how many have more than one fund from our sample.

[25] The funds in the sample also own stakes in 326 financial companies which, presumably, were not part of the universe of privatized companies.

[26] We are also using Blasi and Shleifer's (1995) figure of 9 percent as the average combined stake of voucher funds in companies that have voucher funds among their owners (which, incidentally shows that there is rarely more than one fund among the owners of an average company and that the funds in our sample, being weighted toward greater size, may also hold somewhat higher than average stakes).

behavior of the funds' themselves, the responses to the questionnaire also allow to form a broader picture of the whole postprivatization environment in Russia, including the behavior of company management and other actors on the ownership scene.

Table 4 gives a picture of the funds' portfolios in terms of the number of companies they invest in and presents the types of companies in which the funds in the sample are represented. We see that all the funds are very heavily invested in non-financial companies, and particularly in production companies (which is an artifact of the supply available in voucher privatization, and, to a lesser extent, of the Russian economy as a whole). Smaller funds are more heavily invested in financial companies, in part perhaps because some of them specialize in such holdings and in part because they have greater liquidity needs (and financial companies are considered more liquid)[27]. Also, given the small supply of non-manufacturing companies, larger funds may simply have no choice but to invest heavily in the non-financial sector.

[27] Interviews with small voucher funds in a number of regions of Russia (unpublished pilot study of January 1994).

TABLE 4

COMPANIES IN THE FUNDS' PORTFOLIOS

TYPE OF COMPANY	NUMBER OF FUNDS REPORTING THAT THEY HAVE INVESTED IN A GIVEN TYPE OF COMPANY	NUMBER OF COMPANIES IN A PORTFOLIO (% OF COMPANIES IN A PORTFOLIO)		
		AVERAGE FUND	LARGEST 10% OF FUNDS	SMALLEST 10% OF FUNDS
NON-FINANCIAL COMPANIES:	145	47.7 (89.6%)	81.7 (93.8%)	25.0 (72.9%)
Production companies	144	40.1 (76.7%)	68.5 (77.9%)	21.4 (64.0%)
Service companies	70	3.5 (5.3%)	8.3 (8.1%)	1.8 (4.1%)
Trading companies	80	2.5 (4.2%)	2.8 (4.2%)	1.6 (4.4%)
Other non-financial companies	36	1.7 (3.4%)	2.1 (3.6%)	.2 (.4%)
FINANCIAL INSTITUTIONS:	85	2.3 (10.4%)	2.9 (6.2%)	2.7 (27.1%)
Banks	78	1.7 (7.2%)	2.6 (5.7%)	1.4 (14.3%)
Other financial institutions	35	.6 (3.2%)	.3 (.5%)	1.3 (12.9%)

We have noted already that, given the insider-domination of Russian enterprises, the stakes held by the funds are relatively small. The average sizes of these stakes for different categories of funds are shown in Table 5. Table 5 also shows that the larger funds tend to own larger stakes.[28]

TABLE 5

SIZE DISTRIBUTION OF AVERAGE STAKES HELD BY THE FUNDS

QUARTILE	AVERAGE STAKE HELD BY FUNDS
FIRST QUARTILE	3.86
MEDIAN	6.38
THIRD QUARTILE	9.09
MAXIMUM	18.75
MEAN	6.89
MEAN FOR THE LARGEST 10% FUNDS	9.08
MEAN FOR THE SMALLEST 10% OF FUNDS	4.64
WEIGHTED MEAN[1]	7.29

[1] Weighted by size in terms of the number of companies in the fund's portfolio

Table 6, in turn, shows that not only the average stakes are low; the funds also hold very few large stakes in any of the companies in their portfolios, with blocks of shares of over 25 percent in only 125 companies (1.8 percent of the total).[29] Given the general concentration of ownership in Russia, especially in the hands of the insiders, this severely

[28] See section VI for an analysis of the behavior or larger funds.

[29] As noted above under II.1., 25 percent is also the (unenforced) legal limit of fund ownership in any single company.

restricts the ability of the funds to exercise effective influence over the companies in which they are invested.

TABLE 6

SIZE DISTRIBUTION OF STAKES HELD BY THE FUNDS

SIZE OF STAKES	NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS IN WHICH THE FUNDS HOLD STAKES OF A GIVEN SIZE
Less than 5%	3,941 (57.3%)
5% to 9.99%	1,370 (19.9%)
10% to 19.99%	989 (14.4%)
20% to 25%	457 (6.6%)
25.01% to 49.99%	118 (1.7%)
50% to 74.99%	7 (0.1%)
75% to 99.99%	0
100%	0
TOTAL	6,882 (100%)

Number of valid responses: 141

A peculiarity of the Russian voucher auctions need to be mentioned here in order to keep the size of the average stakes in perspective. On the one hand, the size of the stakes might be taken as an indication of the type of the funds' interest in the companies in their portfolio: the more active funds, for example, will naturally be interested in acquiring larger stakes. But the size of the stake may often be a matter of accident, since the funds did not know in advance how many shares they were bidding for during the voucher auctions.

Bidders were simply told to submit the number of vouchers they were willing to bid for the shares of a given company, and the price of each share was determined by dividing the total number of vouchers by the number of available shares. Each bidder then received the proportion of available shares corresponding to the number of vouchers he had bid.[30] Given the imperfection of information concerning the value of the companies sold at voucher auctions, as well as the unpredictability concerning the number of people who might participate in the auctions,[31] a voucher fund could not confidently predict how many shares it would be able to purchase. Once purchased, the funds were often locked into their holdings, since the liquidity for most of the shares is very low.[32] For this reason, the size of the stakes is a less reliable criterion of the funds' nature than one would otherwise expect.

5. The ownership structure of the funds

Voucher investment funds were designed as private institutions that would potentially play a key role as new outside owners actively promoting firm-level and economy-wide restructuring. To gauge how likely they were to acquit themselves of this task, we looked at who was among their founders (Table 7) and asked the question of whether their starting point predisposed them in what could be seen as the "right" direction.

All funds, as we have seen, were founded as joint stock companies. Under Russian law, this means that a group of initial founders had to form the company to begin with, and

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[30] Another type of bid allowed bidders to list a reservation price, but it was hardly ever used.

[31] The decentralization of the voucher auctions probably contributed to this uncertainty.

[32] See Table 20 below.

then float it on the market (which, in this case, involved issuing the funds' shares primarily in exchange for vouchers received from the population). Although the original ownership structure of the funds (prior to the first public emission of their shares) may be only an imperfect indication of the future behavior of the funds (since the public emission was bound to dilute the original owners), the founders are likely to have retained significant managerial control after the fund went public (indeed, they were the parties choosing the management in the first place).[33] Also, it may be independently interesting to see who was among the funds' founders, since their identity might give an indication of the extent to which attempts might have been made to use the funds as a means for the old institutions to reproduce or perpetuate themselves. Finally, the relationship between voucher funds and other financial institutions may provide some indication of the degree of evolution undergone by both the new and the old financial sector

[33] The funds' management is contracted out to other legal of physical persons, but since the majority of the funds are managed by individuals, rather than companies, data on ownership structure of the management companies is less instructive than that on the initial ownership of the funds themselves, especially since the original fund owners were the ones who decided on the identity of the management. The professional background of individual fund managers interviewed in the survey is similar to that of enterprise managers in Russia: 37.2 percent of all the interviewees were engineers, 37.8 percent economists. 30.4 percent were previously employed in state enterprises, but a large group (27.7 per cent) comes from private companies, both financial and non-financial.

TABLE 7

FOUNDING PARTIES OF VOUCHER INVESTMENT FUNDS

TYPE OF FOUNDING PARTIES	NUMBER OF FUNDS REPORTING THAT ONE OF THE FOUNDERS WAS OF A GIVEN TYPE	AVERAGE PERCENTAGE HELD WHERE PRESENT
PHYSICAL PERSONS:		
MANAGERS OF NON-FINANCIAL COMPANIES	32	38.91
EMPLOYEES OF THE STATE ADMINISTRATION	3	13.67
MANAGERS OR EMPLOYEES OF DOMESTIC FINANCIAL INSTITUTIONS	20	26.2
OTHER DOMESTIC INDIVIDUAL INVESTORS	44	42.05
FOREIGN INDIVIDUAL INVESTORS	0	0
JURIDICAL PERSONS:		
INVESTMENT COMPANIES	27	44.15
BANKS AND OTHER DOMESTIC FINANCIAL INSTITUTIONS	32	37.09
STATE OWNED ENTERPRISES	8	33.25
PRIVATIZED ENTERPRISES	36	53.58
(NEW) PRIVATE ENTERPRISES	82	57.55
FOREIGN BANKS AND FINANCIAL INSTITUTIONS	0	0
OTHER[1]	28	36.3

[2] Includes social organizations, associations, small commercial organizations, and a Russian/foreign joint venture.

5.1. The state

The architects of Russian privatization were very thorough, much more so than their Czech counterparts, in trying to prevent not only direct, but also indirect state ownership of the privatized companies. Thus, not only were state-controlled entities prohibited from bidding for the companies themselves, but also the voucher fund regulations flatly prohibited any state structures or entities controlled by the state (i.e. ones in which the state holds at least a 25 percent stake) to act as founders or co-founders of voucher investment funds. This prohibition was generally observed, although eight funds in the sample report that "state enterprises" were among their co-founders, owning on average a 30 percent stake in the original fund.

The flat prohibition on state involvement was somewhat relaxed when the law was interpreted to allow so-called "social organizations" -- an amorphous group ranging from labor unions to the association of the veterans of the war in Afghanistan -- to act as founders of a fund.[34] Fourteen funds in the sample reported that social organizations were among their co-founders. But in general, the ownership role of the state, either direct or indirect, appears to be minimal.

5.2. Potential circularity of control

The primary investment objects for voucher investment funds were companies whose shares were offered in the privatization process and could be acquired for vouchers. The

[34] The statute on voucher funds prohibited "entities owned by social organizations" to establish such funds. Based on this inconclusive wording of the regulation, the GKI (Russian Ministry of Privatization) decided to allow social organizations themselves to set up funds. See GKI Telegram of February 10, 1993, DV-22/951.

degree to which voucher funds were truly independent could be compromised if the same privatized companies or their management were directly involved in the creation of the voucher funds. Evidence from the sample suggests that potential targets of voucher investment funds were indeed quite active in establishing their future owners: thirty two funds name managers of enterprises, and thirty six name privatized companies as their co-founders. When they were present at the time of founding, managers held, on the average, 38 percent in the original fund, and privatized companies held 54 percent.[35]

5.3. Other financial institutions

The architects of the Russian program were also much more cautious than their Czech counterparts in allowing voucher funds to be linked to other types of financial institutions. The funds were prohibited from acting as banks or insurance companies, and the prohibition on the ownership by state-controlled entities naturally worked to restrict the role of old-style banks in the creation of the funds -- perhaps the most important difference with respect to the Czech funds. But private banks, insurance companies, and other investment institutions were not prohibited from acting as co-founders, and the survey shows that numerous financial institutions did participate: 27 list investment companies, and 33 funds list banks and other financial institutions, including insurance companies, among their founders. Where these actors are present, moreover, they hold very substantial stakes: 44 and 37 percent, respectively. Furthermore, among the 42 voucher funds which are parts of

[35] As we shall see later (Table 19, the presence of privatized companies among a fund's owners has a highly significant dampening effect on the fund's involvement in fundamental restructuring.

a group of affiliated companies, 23 have a bank, 18 a pension fund, 15 an insurance company, and 31 an investment company among the other members of the same group.

In Table 10, we have listed investment companies as founders independently from banks and other financial institutions. The reason for this is that banks, even if they are often new, are likely to include a large number of entities "captured" by the old institutions. Investment companies, on the other hand, are more likely to be the harbingers of a newly evolving financial order, rather than an extension of the existing banking system.

5.4. Foreign financial institutions

In contradistinction to the Czech Republic, foreign financial institutions have been entirely absent from among the founders of voucher funds in Russia, and only two funds report that foreign financial institutions were a part of their management company. This is a rather unfortunate result, since these institutions have many skills lacking in Russia, where financial markets did not exist at all until a few years ago, and they have much greater access to the sorely lacking foreign capital.

5.5. New private founders

By far the largest role as founders of voucher funds is played by new private nonfinancial companies: 82 funds list them among their founders. Many among these founders are likely to be the most independent actors on the Russian corporate scene. But it should also be noted that a large number could be companies formed by managers of the privatized entities attempting to organize their own friendly funds in order to shield their companies against genuine outside influence.

* * *

The landscape of the founders of Russian voucher funds reflects a simple fundamental condition: that new institutions must be built with existing material. It is therefore hardly surprising to find many of the main actors in the old order among the founders of the voucher funds. In the absence of foreign inflow of human capital and expertise, the only truly new players with some track record of economic activity outside the state sector might be the investment companies created in the wake of the first Russian securities regulation in December 1991,[36] and some of the new private actors with a background outside civil service or state enterprise management. But we see a significant diversity of the founders and no clear dominance of any one type committed to a particular policy or strartegy portfolio management.

III. The Investment Environment

1. Access to information and investment criteria

The world in which the Russian voucher funds pick their portfolios and manage their investments is characterized by a remarkable absence of information -- undoubtedly another effect of the insider domination of most Russian firms. As shown in Table 8, most companies do not disclose any financial information to nonshareholders, and when they do disclose it to shareholders, many funds (33.3 per cent) view the information as poorly

[36] Government Regulation No. 78 on Securities of December 28, 1991.

reflecting the actual financial situation and/or performance of the company. Perhaps most astoundingly, 12.5 percent of the funds report that *no* companies in their portfolios give them regular access to financial information, and 49.3 percent report that most companies do not provide such information. As a result, as seen in Table 9, the funds resort to spying on their own companies,[37] or rely in their efforts to monitor the companies in their portfolios on such deceptive indicia of performance as the volume of output.[38]

[37] This practice was also confirmed in a number of informal interviews.

[38] In addition to the effect of insider domination, there may also be another factor limiting the amount of information available to shareholders, namely the fact that most Russian companies engage in widespread tax avoidance and the disclosure of any financial data may get them into trouble with the state (which also happens to be a major shareholder). It may even be said that a rational shareholder in Russia would want the management not to disclose any information, since this may be a simple strategy of maximizing return on capital. We presume, however, that this factor, which was brought to our attention by Professor Bernard Black, is working concurrently with the effects of insider domination and does not invalidate the points made in the text.

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST?	
ALWAYS	31.2
SOMETIMES	36.2
RARELY	14.9
NEVER	17.7
TO WHOM IS FINANCIAL INFORMATION DISCLOSED?	
ANY INTERESTED PARTIES	3.3
CURRENT SHAREHOLDERS ONLY	96.7
ACCURACY OF DISCLOSED INFORMATION	
GOOD	0.8
ADEQUATE	65.9
POOR	33.3

TABLE 9

MEANS BY WHICH FUNDS MONITOR COMPANIES IN THEIR PORTFOLIOS

	PERCENTAGE OF FUNDS
REVIEW OF FINANCIAL DATA	75.4
INFORMAL SOURCES	71.6
SHARE PRICES	70.5
VOLUME OF OUTPUT	64.9

Given the secretiveness of insider-dominated companies and the weakness of other monitoring institutions (the capital market, above all), the question arises as to how the funds actually pick the companies for their portfolios. Table 9 lists the different criteria used by the funds to select companies for investment, and it reveals overall strategies that are understandable under the circumstances, but which differ significantly from what one would expect in a more stable market environment.

The most often used investment criterion is profitability. Although this is a rather standard gauge of success, its usefulness under Russian conditions seems very questionable. Profitability figures are notoriously unreliable in a world in which firms have a very short history of operation under the market system, in which product markets (and prices) are still extremely imperfect, and in which accounting is utterly unreliable. The cost of fixed capital is accounted for in terms of unrealistic book values, receivables and payables are often paper entries, and inflation makes a mockery of most calculations. But profitability may be an indication of a short-term availability of cash, which may attract many cash-strapped funds hoping for quick dividends.

In addition to profitability, the funds seem most often to look to fundamentals that can be relatively easily determined without access to inside information: they look at the value of real estate and the quality of production equipment, and -- most funds being small and regional -- they consider geographical location to be important. By contrast, the funds tend to attach little importance to "business fundamentals," such as the quality of management, even though these might seem to be crucial in an environment in which the outside investor is usually powerless to effect any changes. The reason for this is probably that business fundamentals are very difficult to determine, unless one has personal contacts with the management, in which case the funds are more ready to go in.

Finally, given the imperfection of the capital markets, the funds pay inordinate attention to the liquidity of their investments. The importance of liquidity is further strengthened by the fact that exit is often the only plausible strategy for an outside investor in an insider-dominated Russian environment.

TABLE 10

INVESTMENT CRITERIA USED BY THE FUNDS

INVESTMENT CRITERION	VERY IMPORTANT[1]	NOT IMPORTANT
PROFITABILITY	64.6%	6.2%
LIQUIDITY OF COMPANIES' SHARES	60.0%	13.1%
VALUE OF REAL ESTATE	58.5%	12.3%
QUALITY OF PRODUCTION EQUIPMENT	46.9%	9.2%
LOCATION OF COMPANY	42.3%	13.8%
PERSONAL CONTACTS WITH COMPANY MANAGEMENT	39.2%	26.2%
BUSINESS CONNECTIONS WITH OTHER COMPANIES IN THE FUND'S PORTFOLIO	35.4%	30.0%
EXPECTED COOPERATION WITH MANAGEMENT TO OVERCOME EMPLOYEE RESISTANCE	32.3%	29.2%
SALES REVENUES	23.1%	23.8%
QUALITY OF COMPANY MANAGEMENT	20.0%	32.3%
ACCESS TO STATE CREDITS	16.2%	51.5%
LARGE STAKE HELD BY THE STATE	14.6%	59.2%
ACCESS TO NON-STATE SOURCES OF FINANCE	12.3%	60%

[1] Percentage of funds listing each criterion as being in the "very important" category. Number of valid responses for every row of this table is 130.
Note: We contrast only "very important" vs. "not important" investment factors. Since we eliminated the "moderately important" category, row percentage does not add up to 100.

2. The other players

To understand the dynamics of the Russian corporate scene, a few words must be said about the importance of other actors with whom the voucher funds interact in their attempts to influence the behavior of companies in their portfolios.

We have noted already that corporate insiders are the largest force among the owners of companies in which voucher funds are also among the shareholders -- as shown by Table 11, insider ownership approaches 70 percent of the companies in the funds' portfolios. Even though the funds are the largest shareholders in some 7.7 percent of companies in their portfolios,[39] in most of even those companies the *combined* force of the insiders by far exceeds the voting power of the funds.

[39] All these companies are concentrated in 77 funds, each of which is, on the average, the largest shareholder in some 16 percent of the companies in its portfolio.

TABLE 11

RELATIVE POSITION OF FUNDS, INSIDERS, AND THE STATE

	NUMBER (%[1]) OF COMPANIES	NUMBER OF VALID RESPONSES
NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS IN WHICH THE FUND IS THE LARGEST SHAREHOLDER (AS PERCENTAGE OF TOTAL NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS)	505 (7.7%)	136
NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS IN WHICH THE FUND IS REPRESENTED ON THE BOARD (AS PERCENTAGE OF TOTAL NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS)	1,040 (15.1%)	141
NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS IN WHICH THE INSIDERS (WORKERS AND MANAGEMENT TOGETHER) HOLD MORE THAN 50% OF OUTSTANDING SHARES (AS PERCENTAGE OF THE TOTAL NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS)	3,844 (69.9%)	116
PROPORTION (PER FUND PORTFOLIO) OF COMPANIES IN WHICH THE INSIDERS (WORKERS AND MANAGEMENT TOGETHER) HOLD MORE THAN 50% OF OUTSTANDING SHARES MAXIMUM 75TH PERCENTILE MEDIAN 25TH PERCENTILE	100% 93% 75% .2%	109
NUMBER OF FUNDS REPORTING THAT THE STATE IS A SHAREHOLDER IN ANY OF THE COMPANIES IN THEIR PORTFOLIOS	124 FUNDS; (Number of companies not available)	143
NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS IN WHICH THE STATE IS REPRESENTED ON THE BOARD (AS PERCENTAGE OF THE TOTAL NUMBER OF COMPANIES IN THE FUNDS' PORTFOLIOS)	2,557 (46.9%)	108
PROPORTION (PER FUND PORTFOLIO) OF COMPANIES IN WHICH THE STATE IS REPRESENTED ON THE BOARD OF DIRECTORS MAXIMUM 75TH PERCENTILE MEDIAN 25TH PERCENTILE	100% 98% 53% 9%	106

Next to the combined force of enterprise insiders, and far ahead of the voucher funds, the most important single shareholder in Russian firms remains the state. In the early stages of the privatization process, before any shares were sold to outside owners, the state continued to own the largest block of shares in every enterprise, but there was a limitation on the extent of actual state power in corporate affairs: if the state block was larger than 40 percent, the excess shares were preferred and nonvoting . (Once sold to private parties, the preferred shares changed their status to ordinary common stock.) The state property funds (holding the state shares) then sold a large portion of their initial holdings at voucher auctions, bringing state ownership in most firms to between 10 and 31 percent (with all the state shares being voting common at this point).[40] Thus, even though voucher auctions amounted to significant divestment, they still left the state, when compared with any other individual shareholder, including managers and voucher funds, as the largest blockholder in nearly every Russian firm.

Our survey did not measure directly the extent of state ownership of the companies in funds' portfolios, but the survey data (see Table 11) concerning the frequency with which the state holds seats on the boards of directors confirms the importance of state power in Russian corporate life: while the voucher funds held board seats in only 15.1 percent of companies in their porftolios, the state held such seats in 46.9 percent of cases. Moreover,

[40] The actual number of shares retained by the state depended on the privatization option chosen, the number of shares offered at voucher auctions, and the creation of employee shareholding trusts (FARP). Under privatization option 1, insiders could acquire initially 40% of total shares; adding 29% as the standard amount of shares that was offered at voucher auctions, this leaves 31% for the state. Under privatization option 2, after insider subscription (51%) and voucher auction, usually a block of 20% remained. FARP regulations allowed for an additional 5-10% of total shares to be allocated to an employee trust.

the state seems in most instances to be a manager-friendly shareholder: as shown in Table 12, of 77 funds reporting that the state forms coalitions with other shareholders, 81.8 percent report that the state forms such coalitions with the management or the workers.[41] Thus, the survey indicates that the presence of the state among the shareholders further strengthens the dominance of the insiders in most Russian firms. And since this presence is also likely to continue for the foreseeable future, so is the fact of insider domination.[42]

TABLE 12

THE STATE AS AN ALLY OF OTHER SHAREHOLDERS

TYPE OF SHAREHOLDER	PERCENTAGE OF FUNDS REPORTING THAT THE STATE FORMS COALITIONS WITH THIS TYPE OF SHAREHOLDER[1]
MANAGEMENT	75.3
OUTSIDE INVESTORS (JURIDICAL PERSONS)	24.7
NON-MANAGERIAL EMPLOYEES	6.5
INDIVIDUALS AS OUTSIDE INVESTORS	5.2

[1] The percentages are computed relative to the number of funds reporting that the state forms coalitions with other shareholders.

Although we lack systematic evidence on the behavior of other actors on the roster

[41] A number of informal interviews with voucher investment funds and regional state property funds (which vote the state shares) in several regions conducted in preparation for this survey confirm this result.

[42] For a more detailed description and analysis of the role of the state in privatized companies, see Pistor and Turkewitz (1995).

of shareholders in Russian firms, many of them are also likely to be allied with the management and solidify its control. Thus, for example, some firms are widely believed to have "parked" significant blocks of their shares with customers or suppliers, holding companies, friendly banks (many of which were owned by former state enterprises), or a veriety of related establishments. Also, many Russian companies report having various other "commercial firms" among their largest shareholders. A portion of these firms is sure to consist of *bona fide* investors, genuinely unrelated to the companies they own, but it is also very likely that some of these commercial firms were in fact formed by managers of companies to be privatized or their friends and families in order to increase covertly the extent of managerial control. Such covert managerial purchases were often mentioned in interviews with various parties on the Russian corporate scene, and they are likely to diminish still further the extent of genuine outside ownership.

The remaining outside owners are the most likely to be the dispersed, usually very small individual shareholders.[43] The voucher funds are thus probably the most important outside owners, and even though some of these funds may have also been "captured" by managerial interests, they are probably overall the most genuinely independent among the non-insider shareholders of Russian corporations.[44] In this sense, it may be said that their

[43] The level of foreign ownership in most Russian privatized firms is so far still so small as to be safely ignored.

[44] We made numerous efforts to identify in our sample the funds that might have been created or captured by managers of privatized enterprises in order to protect the insiders against genuine outside ownership. Although, as we shall see, some funds are clearly more friendly to managers than others, the presence of managerial interests is so pervasive among nearly all funds -- which, given the extent of insider domination, simply must cooperate with management in order to achieve any of their objectives -- that it is impossible to isolate any group of distinctly "managerialist" funds.

responses to the peculiar environment in which they must act are the most indicative of the predicament of an outsider investor in the insider-dominated Russian firms. In fact, how successful they are in breaking down the barriers posed by the insiders may be one of the most important questions concerning the future of corporate governance in Russia.

IV. The Role and Extent of Shareholder Activism in Russian Post-Privatization Environment

One of the main purposes, indeed, next to the objective of depoliticization, *the* main purpose, of privatization was to change the way companies had been run under the old communist system. In part, the Russian privatization scheme was to change the incentives of management by giving managers partial ownership of their enterprises. But in part the improvement was to come from better monitoring and supervision of management performance by the new private owners. The restructuring of privatized firms was thus to come in a significant part from the activism of new shareholders, with voucher funds playing a leading role in this respect. In this section we will inquire into how active the voucher funds in fact are in corporate affairs and what factors determine the nature and extent of their activism.

In a developed economy, shareholder activism is not a preferred strategy of most investors. Monitoring is costly and requires special skills, while returns from it must usually be shared with other, passive shareholders. A large number of investors in advanced markets prefer therefore to remain passive and rely on others to do the monitoring and supervision of management. When they are disappointed by corporate performance, they usually prefer "exit" (i.e. sale of their stakes) to "voice" (i.e. participation in corporate restructuring). Moreover, shareholder activism, even when it does occur in Western economies, is not, except in very special markets, an everyday occurrence -- it is rather a strategy of last resort, with the investor interfering with management only in times of corporate difficulties that raise the possibility of managerial ineptitude or malfeasance.

In a transition economy, however, one might expect activism to be much more prevalent among investors. Liquidity and corporate governance institutions relied upon by Western minority investors for the protection of their interests are not present in most transition economies, so that exit is often difficult and costly, and the ability of an investor to "free ride" on the monitoring done by others is also limited. Indeed, the very need to protect one's investment from managerial overreaching or outright dishonesty often makes shareholder activism necessary. At the same time, returns from investor activism are also potentially greater in transition economies than in the more stable systems, at least with respect to those companies that do have a future in the new economic order, because companies are more mismanaged and more value can be created through some obvious forms of restructuring. Furthermore, in the absence of well developed markets, shareholder activism may be the only way to acquire valuable information affecting investment strategies and the management of one's portfolio.

1. Self-proclaimed activism

As expected, Russian voucher funds engage in a significant amount of shareholder activism, with only a relatively small minority (19.4 per cent) adopting a purely passive stance. The remaining 80.06 percent (116 out of 144 funds in our sample) claim active involvement in important decisions in at least some of the companies in their portfolio (Table 13). Of these, 78.4 percent (87 funds) report that shareholder activism is their general strategy, and 85.6 percent (95 funds) believe that activism is necessary (important or very important) to protect their investment (Table 14).

TABLE 13

THE EXTENT OF THE FUNDS' ACTIVISM

COMPANIES IN THE FUND'S PORTFOLIO IN WHICH THE FUND IS AN ACTIVE INVESTOR[1]	PERCENTAGE OF FUNDS[2]
NONE	19.4
SOME	65.3
MAJORITY	13.2
ALL	2.1

[1] A fund is considered to be an "active investor" if it spends significant resources and/or effort on monitoring and/or influencing major decisions, such as employment, investment, structure of production, sales, organization, etc.

[2] Out of 144 valid responses.

Another expected reason cited by many funds to explain their activism (as seen in Table 14) is the lack of liquidity, which impedes exit when a company is underperforming. But what may come as a surprise, and throw significant light on the nature of activism of the Russian funds, is the near universality with which the funds cite the ability to cooperate with management as a reason for their activism, at least in some of the companies in their portfolios. Cooperation with management may, of course, be quite common among activist shareholders in more advanced economies, where management is likely to be ultimately chosen by powerful investors. But in a transition economy, where low quality and opportunism of management are among the main causes of poor performance, and where agency problems are likely to be rampant,[45] this high degree of cooperation between management and the new shareholders is not likely to occur in the absence of special circumstances. Under Russian conditions, these special circumstances are, of course, the very high degree of insider ownership, which makes it extremely hard to exercise any influence over Russian firms, unless the cooperation of the management is secured. But this very fact also means that the nature of shareholder activism in Russia is likely to be severely restricted by the need to secure management cooperation, and that the measures that can be undertaken by the activist funds are likely to fall far short of any radical restructuring that would be apt to provoke managerial opposition. In particular, as we shall see below, any attempts to foster restructuring by management changes are severely restricted by the insider domination of Russian firms.

[45] Chapter 5 in Frydman and Rapaczynski (1994).

TABLE 14

REASONS FOR THE FUNDS' ACTIVISM

REASON FOR THE FUND'S ACTIVISM IN AT LEAST SOME OF THE COMPANIES IN ITS PORTFOLIO	% OF FUNDS[1] REPORTING THAT A GIVEN REASON IS IMPORTANT
THE FUND HAS BEEN ABLE TO SECURE SUFFICIENT COOPERATION OF THE MANAGEMENT TO ENABLE IT TO EXERCISE EFFECTIVE INFLUENCE OVER MAJOR DECISIONS	90.1
THE FUND HAS TO BE ACTIVE TO PROTECT THE VALUE OF ITS INVESTMENTS BECAUSE IT CANNOT EASILY SELL SHARES IN CASE THE COMPANY'S PERFORMANCE IS CONSIDERED UNSATISFACTORY	85.6
THE FUND HOLDS A SUFFICIENTLY LARGE STAKE IN THE COMPANY FOR THE BENEFITS OF MONITORING TO EXCEED ITS COSTS	85.6
THE FUND HAS BEEN ABLE TO SECURE THE COOPERATION OF OTHER POWERFUL OUTSIDE SHAREHOLDERS TO ENABLE IT TO EXERCISE EFFECTIVE INFLUENCE OVER MAJOR DECISIONS	81.1
THE FUND'S INVESTMENT STRATEGY IS TO BE AN ACTIVE INVESTOR IN THE COMPANIES IN ITS PORTFOLIO	78.4
ALTHOUGH THE FUND HOLDS A SMALL STAKE IN THE COMPANY, THE FUND MONITORS THE COMPANY IN ASSOCIATION WITH OR ON BEHALF OF OTHER SHAREHOLDERS	74.8
THE FUND HAS BEEN ABLE TO SECURE THE COOPERATION OF NON-MANAGERIAL EMPLOYEES TO ENABLE IT TO EXERCISE EFFECTIVE INFLUENCE OVER MAJOR DECISIONS	58.6

[1] Out of 111 valid responses

Another surprising fact revealed in Table 23 is the frequency with which the funds claim that their stakes are large enough for the benefits of monitoring to exceed the costs, since we know that the average stakes held by the funds (shown in Table 5) are quite modest, and, generally, the number of companies in which the funds hold large stakes (shown in Table 6) is very small as well. There may be a number of explanations for this phenomenon. First, the survey question asked for reasons for activism in *at least some* (and not necessarily all) of the companies in the fund's portfolio, so that it might have been sufficient for a given fund to own significant stakes in no more than one company to cite the size of its stake as a reason for activism. The second, and more interesting, explanation may be related to the already mentioned conjecture that the returns from activism in transition economies may be significantly larger than in the more advanced economies, where simple restructuring measures are less likely to make a noticeable difference in performance. Consequently, although the funds hold relatively small number of stakes that would be considered, under normal conditions prevailing in more advanced economies, sufficiently large for the benefits of monitoring to warrant the cost, smaller stakes may be sufficient to induce shareholder activism in transition economies, despite the well known free-rider problems.

Finally, Table 14 reveals the frequency with which shareholder activism in Russia involves coalition building, both among the outsiders and between the funds and some non-managerial insider interests, that may increase the power of the funds in their efforts to influence corporate affairs. We shall return to this aspect of Russian corporate governance after reviewing some other facets of the funds' activism.

2. Board representation and shareholder coalitions

Another clear sign of shareholder activism of voucher funds is the frequency with which they participate in the governance bodies of Russian firms. Thus, 111 funds (78.7 percent of valid observations) report that they hold seats on the boards of directors in some of the companies in their portfolios.[46] Extrapolating from our sample, this would mean that approximately 15.1 percent of all privatized companies that have a voucher fund among their shareholders also have a voucher fund on their boards.[47]

How do voucher funds obtain their board seats? Nearly all funds report that the size of the stake is an important factor (see Table 15), and, judging from the number of seats obtained, a stake in the range of 15 percent seems to be sufficient.[48] This threshold is not surprising, although it would probably be significantly lower if regulations concerning independent directors and mandatory cumulative voting were to be enforced.[49]

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[46] As seen in Table 15, the median for the number of seats held by a fund is much smaller than the mean. The reason for this skewed distribution is that larger funds with higher stakes hold disproportionately more board seats than the smaller funds.

[47] 26 funds also report that they are represented on the management board. Six of these probably misunderstood the question, since they confused positions on the Management Board with those on the Council of Directors (which is not a managing body). But six funds report that the managing directors of some of the companies in their portfolios are "representatives" of the fund, and the same number of funds list chief financial officers as their representatives (two list the Economic Director). From other responses to the survey, it appears that 11 of the 26 funds reporting representation on the management board may in fact be "captured" and the representation of these funds among the management is likely either to reflect the dependence of the fund on the firm, rather than the other way around, or to result from a recreation of old interenterprise links on the ownership level. Still, the evidence does indicate that in a relatively small number of cases (amounting, on average, to 1.7 percent of companies in the funds' portfolios), the funds have a "hands on" involvement in management.

[48] See Table 6 for a distribution of the funds' stakes according to size. Although no exact calculations are possible from our data, there are probably fewer than 1,040 companies in the portfolios of our funds in which a fund holds a 15 percent (or larger) stake. (The funds hold 1,040 board seats.) But some board seats are obtained on the basis of coalitions, rather than the size of individual stakes (see below), and this makes the threshold of 15 percent roughly appropriate.

[49] These provisions were included in the Privatization Program for 1994, which was adopted by a presidential decree. See footnote 19 above.

TABLE 15

FUNDS AND BOARD OF DIRECTORS

NUMBER OF FUNDS REPRESENTED ON BOARD OF DIRECTORS	111
TOTAL NUMBER OF COMPANIES WITH A FUND AS A BOARD MEMBER	1,040
NUMBER OF COMPANIES PER FUND PORTFOLIO IN WHICH THE FUND IS REPRESENTED ON THE BOARD OF DIRECTORS[1]	
MAXIMUM	50
75TH PERCENTILE	10
MEDIAN	3
25TH PERCENTILE	1
AVERAGE	7.4
IMPORTANT FACTORS TO OBTAIN A SEAT ON THE BOARD OF DIRECTORS (Percentage of funds reporting that a given factor is important[1])	
SIZE OF STAKE HELD	99.3%
COOPERATION WITH MANAGEMENT	94.3%
COOPERATION WITH OTHER OUTSIDE INVESTORS	88.6%
COOPERATION WITH THE STATE	58.6%
COOPERATION WITH WORKERS	47.9%
BENEFITS OF BOARD REPRESENTATION AS SEEN BY THE FUNDS (Percentage of funds reporting a given benefit[2])	
INFLUENCE ON MANAGEMENT STRATEGY	87.5%
ACCESS TO INFORMATION	84.7%
INFLUENCE ON DIVIDEND POLICY	76.4%

[1] Out of 140 valid responses.
[2] Out of 144 valid responses.

The funds also acquire board seats by forming coalitions with other shareholders -- the most frequent partners in such alliances are shown in Table 16. Significantly, management is, again, the most common ally and, independently, 94.3 percent of the funds also report that cooperation with management is an important factor in obtaining a board seat (Table 15). This probably means that most boards are "packed" with managerial members and limits the type of activism in which the funds may engage. Moreover, the presence of voucher funds on boards of directors should be viewed in light of the fact that the board is generally a weak body under Russian law, with no power to dismiss the General Director.[50] But the funds also try to get board seats by forming coalitions with other outside investors, especially other funds and investment companies. These two types of shareholders represent a relatively small percentage of ownership, but they are among the most independent institutions, with fewer ties to the previous regime, and they figure as primary allies of the funds much more often than their mere size as shareholders would lead one to expect. This may be an indication that the funds' behavior on the boards is not always manager-friendly. Indeed, as we shall see, the funds do sometimes participate in the dismissals of managers and other forms of more "fundamental" restructuring.

[50] The right to dismiss the General Director is vested exclusively in the shareholder meeting. Art. 124 of the Statute on Joint Stock Companies, Regulation No. 601 of the RSFSR Council of Ministers, 25 December 1990, and Art. 6.13 of the Model Statute for privatized companies adopted by Presidential Decree No. 721 of 1 July 1992. Under the recently enacted Civil Code, this right may now be delegated to the Council of Directors, but only if the company's by-laws so provide (Art. 103).

TABLE 16

THE FUNDS' SUPPORTERS FOR BOARD REPRESENTATION

TYPE OF SHAREHOLDER	PERCENTAGE OF FUNDS LISTING A GIVEN SHAREHOLDER AS ONE OF THE TOP THREE THE FUND COOPERATES WITH IN ORDER TO OBTAIN A BOARD SEAT[1]
MANAGEMENT	82.7
VOUCHER FUNDS	74.4
THE STATE	30.8
INVESTMENT COMPANIES	24.8
DOMESTIC COMMERCIAL ENTITIES	21.8
BANKS	12.0
PHYSICAL PERSONS	12.0
SUBGROUPS AMONG NON-MANAGERIAL EMPLOYEES	10.5
NON-MANAGERIAL EMPLOYEES	6.0
FOREIGN FINANCIAL INVESTORS	3.0
PENSION FUNDS AND INSURANCE COMPANIES	4.0
FOREIGN TRADE INVESTORS	0

A separate survey question inquired, more generally, who are the funds' main allies among shareholders and which shareholders are the least cooperative from the funds' point of view. The answers to this question reveal a somewhat more complicated picture than the tactical alliances concerning support in board elections (see Table 17). Over sixty percent of the funds still list management among their three most important allies, which indicates not only that the funds must work with management if they want to be active at all, but potentially also that the interests of these two groups may not be as diverse as one might suspect: indeed, some managers may not be totally hostile to outside interests, and some funds might be "captured" by, or otherwise linked to, managerial interests, so that they cannot be identified with "new" forces, opposed to the old industrial *nomenklatura*. Equally significantly, however, nearly a third of the funds also list management amont the three most uncooperative shareholders, which probably confirms our view of the funds as the most independent group of outside shareholders.

TABLE 17

CORPORATE ALLIES OF THE FUNDS

TYPE OF SHAREHOLDER	PERCENTAGE OF FUNDS LISTING A GIVEN SHAREHOLDER AMONG THREE MOST COOPERATIVE SHARHOLDERS[1]	PERCENTAGE OF FUNDS LISTING A GIVEN SHAREHOLDER AMONG THREE MOST UNCOOPERATIVE SHAREHOLDERS[1]
MANAGEMENT	67.2	32.8
VOUCHER FUNDS	64.1	19.5
INVESTMENT COMPANIES	33.6	5.5
BANKS	32.0	7.8
DOMESTIC COMMERCIAL ENTITIES	22.7	16.4
PHYSICAL PERSONS	17.2	24.2
SUBGROUPS AMONG NON-MANAGERIAL EMPLOYEES	11.7	43.0
NON-MANAGERIAL EMPLOYEES	11.7	46.9
FOREIGN FINANCIAL INVESTORS	10.9	6.3
THE STATE	10.2	50
PENSION FUNDS AND INSURANCE COMPANIES	9.4	14.1
FOREIGN TRADE INVESTORS	4.7	7.0

[1] Out of 128 valid responses.

If the funds find ways to work with management, they are not nearly as successful in forming lasting coalitions with non-managerial employees: barely over 11 percent list these groups as their allies and nearly half see them as among the most uncooperative. In light of what is known about alliances between workers and management in those Western countries in which employees are represented on the governing bodies of companies, this result is not surprising, but it does go against some of the hopes of the the architects of Russian privatization, who had anticipated that workers would not be hostile to outside owners.

Finally, the funds find the state to be the most uncooperative shareholder of all. The funds themselves view the state as, on the whole, more of a negative rather than positive factor: 31.5 percent believe that the presence of the state among the other shareholders has a negative impact on the value of their investment, while only 8.1 percent view it as having a positive impact. At the same time, 60.5 percent of the funds view the state's presence as "neutral." This large number of indifferent respondents is probably simply a result of the state's omnipresence among the shareholders of Russian corporations, but it may also be an indication that the funds, while clearly not in favor of state ownership, are not that hostile to it as well.

Whatever the funds' own attitude, they clearly perceive the state as hostile to their interests: 50 percent view it as among the most uncooperative shareholders, and only 10,2 percent report that the state is among their allies. Overall, then, the interests of the funds and the state seem to be among the most divergent among the important actors on the Russian corporate scene, and, to the extent that voucher funds become more influential over time, this may well serve the depoliticization of Russian companies, which the Russian reformers defined as one of the two major objectives of privatization. Until then, however, the state, as we have seen (Table 12), is in a firm coalition with the management on the firm level, and it seems that the management is able to cooperate with both the state and the voucher funds, even if the latter two have little sympathy for each other. This is probably another effect of the dominant position of the management, which may be able to shift its alliances, depending on the issues at hand, without serious risk that its two outside partners combine together to challenge its position of control.

(It may be interesting to note that of the nine funds that view the presence of the state as enhancing the value of their investment, seven also list management among their top allies. These are likely to be managerially dominated funds, and, as the numbers suggest, the tripartite unholy alliance is probably an exception rather than the rule.)

3. Services provided by the funds

Fund activism is not limited to board representation; according to their reports, the funds also provide a significant number of services to the companies in their portfolios. In fact, as may be observed from Table 18, they see themselves as providing quite an array of such services, from arranging all kinds of contacts to providing expertise in the areas of management, restructuring, and investment. Some of these reports may perhaps be self-serving, especially since most funds are unlikely to have special "in house" expertise in many of these areas and only relatively few report using outside help in this connection. Also, some of these "services" may be provided by the managerially captured funds, and may have less to do with genuine restructuring, and more with reconstructing the old networks of connections among producers, customers, and suppliers who used to be tied together in the former branch ministries and various *nomenklatura* associations. But still, the number of reported services is very large and it indicates an encouraging degree of constructive activism on the part of a very significant number of funds. Of particular interest here may be the fact that between 19 and 24 percent of the funds report providing various kinds of access to foreign credits, customers, or suppliers. These numbers may not be huge, as compared to the other forms of services, but given the isolation of the Russian economy and the extremely low levels of foreign ownership or management participation in the voucher funds, they are nevertheless very significant; indeed, one of the main function of privatization investment funds, as originally proposed, was to facilitate precisely these kinds of business contacts and interactions.[51]

TABLE 18

SERVICES PROVIDED BY FUNDS TO COMPANIES IN THEIR PORTFOLIOS

TYPES OF SERVICE PROVIDED	PERCENTAGE OF FUNDS PROVIDING THE SERVICE THEMSELVES OR ARRANGING FOR SERVICE PROVIDED BY OTHERS[1]
INVESTMENT EXPERTISE	63.6
EXPERTISE IN RESTRUCTURING OR REORGANIZING THE COMPANY	53.4
MANAGEMENT EXPERTISE	44.9
TECHNICAL KNOW HOW	20.3
ARRANGING ACCESS TO DOMESTIC CUSTOMERS	63.6
ARRANGING ACCESS TO DOMESTIC SUPPLIERS	44.9
ARRANGING ACCESS TO FOREIGN CUSTOMERS	23.9
ARRANGING ACCESS TO FOREIGN SUPPLIERS	19.7
EXTENDING CREDIT TO THE COMPANY	18.5
ARRANGING ACCESS TO CREDITS	
ACCESS TO DOMESTIC NON-STATE CREDITS	42.4
ACCESS TO FOREIGN CREDITS	19.0
ACCESS TO STATE CREDITS	14.4

[1] The funds included reported providing a given service to at least one company in their portfolio.

[51] Chapter 1 in Frydman and Rapaczynski (1994).

4. The extent of fundamental restructuring and the limits of shareholder activism

We have seen that, as expected, voucher funds view shareholder activism as necessary to protect their investment during the period of economic transition. We have also conjectured that their returns from activism may be high enough to outweigh its cost even at relatively low levels of ownership. But what exactly is it that the funds are getting from their activism under the very special Russian conditions?

According to their own perception, activism, and specifically seats on boards of directors, are useful for influencing management strategies, obtaining information, and influencing dividend policy (see Table 18). Our data independently confirm these reports, at least with respect to access to information, which is very strongly correlated with having a seat on the board of directors. It is thus reasonable to believe that the other reported benefits are also real, and they provide a plausible indication that our conjecture about high returns from activism is indeed correct. Under Russian conditions, privileged access to information is key to a successful investment strategy, since publicly available information is very scarce and the market for this kind of knowledge is extremely imperfect. Moreover, the ability to influence dividend strategy is also crucial for enhancing returns, given that the insiders have very little incentive to distribute any excess cash to shareholders, instead of consuming it in wages and other privileges or squandering it in inefficient investments.[52]

[52] This is not to deny that Russian firms often are in dire need of additional investment, so that a dividend-maximizing policy may be harmful to their future prospects. But indiscriminate investment policy (as well as unwillingness and inability to retrench or cut costs) was an old disease of the Soviet system which continues to shape the attitudes of many of Russian managers. At the same time, contrary to widespread belief that the cash-poor voucher funds would demand dividends at all costs, there is no evidence of such an attitude in our survey -- indeed, the funds rarely cite cash constraints as a reason for their actions. There is thus no particular reason to believe that the funds systematically prefer increased dividends also in those cases in which the management can make a persuasive case

But returns from shareholder activism are also limited, under Russian conditions, by the extent of insider domination.[53] The funds may gain some voice in company matters, and the management may, in some cases, be willing to compromise on the absoluteness of its control in exchange for services provided by the funds or, when the ownership share commanded by the management is in fact less than fully controlling, in exchange for the funds' support against other shareholders. The funds seem to wield even this limited influence in only a minority -- still rather small one at this point -- of the companies in which they are invested.[54] Judging by such matters as the dismal access to financial data of most companies in their portfolios (see Table 8), they seem to have next to no impact on a great majority of their firms.

The funds' ability to act is particularly insignificant when it comes to more fundamental forms of restructuring, such as effecting the much needed changes in management personnel. The most drastic anti-managerialist measure -- firing the general director -- is still a rarity in Russia, despite the fact that most managers are former *nomenklatura* people, often chosen for their loyalty rather than skills, and nearly always

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for increased investment.

In addition to putting pressure on the management to pay dividends, and thus increasing its accountability for investment projects (as well as, perhaps, contributing to much needed economywide reallocation of capital), the voucher funds also attempt to enhance directly the efficiency of the management's investment policies; or at least they claim they attempt this, since 63.6 percent of them report providing investment expertise to companies in their portfolios -- the type of service most often provided by the voucher funds (see Table 18).

[53] As we shall see in the next section, the activism of the funds may also be limited by the opportunities available in trading, despite the underdevelopment of the capital markets in Russia.

[54] We should remember that the funds are represented on the boards of only 1,040 companies, which amount to 7.4 percent of their portfolios (see Table 15). They may exert some influence in a few other companies, especially when they are allied with other shareholders who may represent them on the board, but the total numbers are still quite small.

firmly rooted in the old ways of doing things. In our sample, only 69 funds report any dismissals of general directors in any companies in their portfolios, and the total number of cases reported, including possible overlaps, is 174. This number amounts to 2.6 percent of companies in all of the funds' portfolios.[55] Furthermore, among the 69 funds reporting that a general director was fired in any company in their portfolios, only 51 claim to have actively participated in such dismissals.[56] Moreover, the relatively small stakes held by the funds mean that the funds participating in dismissals of managers must have had the cooperation of other owners, in many (perhaps most) cases including insiders. Dismissals may thus be occurring primarily in the most egregious cases of incompetence or dishonesty and, except for very few cases, not be a particularly strong indication of genuine restructuring. But even if only some of these cases indicate the presence of more fundamental restructuring on the company level, they may be quite significant for the future.

Consequently, in order to gain better insight into the nature of managerial personnel changes on the company level, we modelled the relation between the number of dismissals of a general director in the funds' portfolios and such explanatory variables as the size of the fund's portfolio, the degree of insider domination of the companies in which the fund is invested, the average size of the fund's' stakes, and the ownership structure of the fund. Estimates of the model, which measures the factors that determine, on the margin, the

[55] This figure is much smaller than the one reported, on the basis of more limited evidence, by Shleifer and Vasiliev (1995).

[56] It is worth noting that for even for this group of "activist" funds the number of dismissals per fund is quite small: 21 funds participated in the firing of 1 director; 23 funds in firing 2; 2 funds in firing 3; and 1 fund in firing 4, 5, 6, 10, and 20 directors respectively. Overall, these figures, including the obvious outlier, amount to 6.8% of the companies in an average fund's portfolio.

dismissal of top executive personnel, are presented in Table 19.

TABLE 19

TURNOVER OF TOP MANAGEMENT

	DEPENDENT VARIABLE	
EXPLANATORY VARIABLES	PROBABILITY THAT NUMBER OF DISMISSALS OF GENERAL DIRECTORS IN WHICH THE FUND ACTIVELY PARTICIPATED IS GREATER THAN 0[1]	PROBABILITY THAT NUMBER OF DISMISSALS OF GENERAL DIRECTORS IN WHICH THE FUND ACTIVELY PARTICIPATED IS GREATER THAN 1[1]
NUMBER OF COMPANIES IN THE FUND'S PORTFOLIO	.017 (.06)	.018 (.04)
NUMBER OF PRIVATIZED COMPANIES AMONG THE FUND'S FOUNDERS	-.045 (.006)	-.074 (.05)
PROPORTION OF COMPANIES IN THE FUND'S PORTFOLIO IN WHICH INSIDERS (WORKERS AND MANAGEMENT TOGETHER) HOLD MORE THAN 50% OF OUTSTANDING SHARES	-1.7 (.02)	-2.1 (.015)
MEAN STAKE HELD BY THE FUND FOR FUNDS WITH AVERAGE STAKES BETWEEN 4% AND 7.5%, AND REPORTING THAT OTHER FUNDS ARE AMONG THEIR TOP THREE ALLIES	36.9 (.007)	40.5 (.004)
MEAN STAKE HELD BY THE FUND FOR FUNDS WITH AVERAGE STAKES BETWEEN 7.5% AND 18.75%	10.5 (.08)	11.9 (.07)
DUMMY VARIABLE: =1, IF MANAGEMENT IS AMONG TOP THREE ALLIES OF THE FUND[2]	-.27 (.65)	-1.41 (.04)
LIKELIHOOD RATIO STATISTIC[3]	28.5 (.0001)	39.5 (.0001)
ASSOCIATION OF PREDICTED AND OBSERVED PROBABILITIES	85%	89%
NUMBER OF OBSERVATIONS	69	69

[1] MAXIMUM LIKELIHOOD ESTIMATES OF LOGISTIC EQUATION; ASYMPTOTIC P-VALUES IN PARENTHESES

[2] =0, OTHERWISE

FOR A DISCUSSION OF METHODOLOGICAL ISSUES RELATED TO THIS AND OTHER STATISTICAL TABLES SEE APPENDIX I

Unsurprisingly, the model reveals that, on the margin, the number of dismissals depends on the number of companies in the fund's portfolio, although, given the overall small number of dismissals, the actual coefficient is quite small: by adding an additional company to a fund's portfolio, the chances of an additional firing increase by less than 2 percent. But, in accordance with our hypothesis that executive dismissals (and other forms of fundamental restructuring) are prevented by insider domination, even this effect is more than nullified by insider domination of the companies in the fund's portfolio: for each additional percent of companies in the fund's portfolio that are more than 50 percent insider-owned (which usually amounts to much less than one more insider dominated company), the dampening effect on the probability of an additional dismissal is also about 2 (1.7 to 2.1) percent. The probability of the fund's involvement in any dismissals also decreases with the number of privatized companies among the fund's founders -- a feature which, we conjectured, is a telltale of the "managerialist" nature of the fund itself.[57]

The results of the model concerning the relation between participation in executive dismissals and the average size of the stakes in the fund's portfolio are of particular interest. First, the effect of the size of the stakes on the firing of general directors is nonlinear: there is no significant correlation between the two for funds with very small average stakes (under 4 per cent), and the effects are quite different for average stakes in the range below 7.5 percent and those above it.[58] For funds with average stakes in the range

[57] See above section II.5.

[58] The highest average stake in the sample was 18.75 percent.

of 4 to 7.5 percent, an increase in the size of the stake is by itself insignificant with respect to executive dismissals -- not a surprising result, since firing a general director is a serious decision on which a small shareholder might not have a significant impact, regardless of whether he owns 4 or 5 percent of the shares. But when a fund in this ownership range reports that other voucher funds are among its top three allies, the size of the stake becomes very significant: for every one percent increase in the size of the fund's average stake, the probability of the fund's participating in the firing of a general director increases by some 4 percent -- quite a large jump, given how rare such dismissals are. In other words, when funds enter into coalitions with each other, their power seems to increase very rapidly and each percent of increase in ownership stakes begins to matter.

The effect of coalitions seems to dissipate when the average size of a fund's stake reaches 7.5 percent, which is probably the size at which funds become influential on their own. But this does not mean that a further increase in average size of the stake is equivalent to an automatic significant increase in executive dismissals. Instead, such a correlation exists only when the equation controls for the fund's relation to management. If management-friendliness (measured by whether the funds consider management to be among their top allies) is included among the explanatory variables (as is the case in Table 19), any increase in average stakes significantly increases the likelihood of additional executive dismissals. But if this variable is removed from the equation, the correlation between the size of the average stake and executive dismissals is significant for the firing of a second director in the fund's portfolio (very few funds fire more than two), but not for the dismissal of the first. The likely meaning of this is related to the conjecture that executive dismissals, under Russian conditions, often involve cases of mere incompetence or dishonesty, rather than post-privatization restructuring. Having participated in a dismissal of a director in one company in one' portfolio, therefore, does not necessarily indicate anything special about the fund's involvement in fundamental changes at the company level, especially if many funds with larger stakes are managerially controlled or otherwise manager-friendly. But a dismissal of a second or third director is probably different: it might very well be an indication of an attempt at restructuring, and a success in this (which, more than the relatively uncontroversial cases of dismissals, involves overcoming significant opposition) depends on the size of the stake.

Given the overall very small number of executive dismissals in Russia, the model's estimates of marginal effects of various factors should be treated with appropriate caution. Firing of top managers is so rare at this point that its effects are likely to be of no significance for the economy as a whole. But the model does reveal some tentative signs of restructuring in connection with the few cases of dismissals that actually occur, and this may be a harbinger of some good news to come. If the pressure on the opening of Russian companies intensifies, the funds seem to represent outside forces interested in fundamental restructuring. Until that happens, however, voucher funds are unlikely to exercise sufficient influence to make a difference.

The funds play even less of a role in the process of downsizing employment (other than executive dismissals) in the notoriously overstaffed Russian firms. To be sure, an outside shareholder might not usually be very actively involved in laying off nonmanagerial employees, but funds pursuing a consistent strategy of restructuring could be expected to insist on changes in this respect. Only 11 percent (out of 136) of the funds in our survey, however, report dismissals of substantial numbers of employees in the companies in their portfolio, and the reports involve only 132 companies (including overlaps), that is 1.9 percent of the total in which the funds are invested. Although the funds may not be well informed about the overall instances of dismissals, it is certainly significant that in none of the cases in which dismissals occurred, did a voucher fund play an active role.

V. Trading

1. The importance of trading in Russia

We have explained already that, as compared to countries in which markets, especially capital markets, are more developed, one should expect more shareholder activism and less trading in the East European economies in transition. Despite this, trading is a surprisingly important activity of the Russian voucher funds, with 57% of the funds reporting that they are actively trading on the secondary market. One obvious reason for this is that, given insider domination of Russian firms, most forms of shareholder activism are blocked for outside investors. As a result, exit, even if liquidity is limited and the capital markets very imperfect, may often seem preferable to being locked into one's holdings without any realistic chance of exercising the option of "voice." Indeed, we are faced with a somewhat paradoxical situation: by the funds' own admission, the shares they hold are largely illiquid, and yet liquidity was one of the main criteria of their acquisitions.[59]

Another factor that may have contributed to high levels of trading among Russian funds may be that, for reasons that need further investigation, the shares of many Russian companies were extremely undervalued in the early stages of the privatization process.[60] Large profits could thus be made from simply selling the stakes acquired at voucher auctions, as well as from active trading on the secondary market.[61] This might have raised the opportunity cost of restructuring and additionally detracted from the incentives of Russian funds to become active shareholders.

While trading is an important activity of voucher funds, it is not one that comes without obstacles. Table 20 reflects the major features of the Russian capital market as seen through the eyes of voucher funds in the summer of 1994.

[59] 61.5 percent of all funds in the sample view liquidity as a very important investment criterion and further 26.6 percent see it as moderately important.

[60] Lack of confidence in the success of the program may have played a role, as well as no belief that the insiders of Russian companies would ever respect the rights of outside owners (Frydman and Rapaczynski (1994), ch. 6). Nontransparency of the decentralized auctions, often de facto excluding many potential bidders, may have also contributed to the low price levels.

[61] 63 percent of the 103 funds that decreased their stakes in some companies cited the opportunity of making large profits as their reason.

TABLE 20

THE MARKET FOR SHARES

	PERCENTAGE OF FUNDS
TYPE OF MARKET ON WHICH THE FUND CARRIES MOST OF ITS TRADES	
STOCK EXCHANGE	11.4
PRIVATE TRADES	88.6
SCOPE OF MARKET ON WHICH MOST OF THE FUND'S COMPANIES ARE TRADED	
NATIONAL	39.5
REGIONAL	36
LOCAL	24.5
AVERAGE FREQUENCY WITH WHICH THE FUND'S COMPANIES ARE TRADED	
IRREGULAR	
REGULAR	59.4
of which	40.6
WEEKLY	
MONTHLY	18.9
QUARTERLY	9.9
	11.8
AVERAGE PERCENTAGE OF THE FUND'S COMPANIES' TRADED	24.90

The data confirm the obvious fact that capital markets are still very much underdeveloped: most shares are traded off market, and the official stock markets play a rather minor role. Markets are also segmented, and the funds report that, in a majority of cases, shares of their companies are traded on either a regional or a strictly local market. Indeed, most funds report no regular trade in their companies' shares: their trades are simply triggered by demand from a domestic or foreign investor attempting to gain control,[62] with most voucher funds merely free-riding on such events.

[62]50% of all funds in the sample and 85.9% of those funds that say that shares in the companies they invest in are traded irregularly report that these are the main reasons for trades to occur.

2. The effects of insider domination on securities trading in Russia

In addition to the weak development of capital markets, Russian traders also face other obstacles, related to the insider domination of privatized firms. As evidenced in Table 21, the funds have been largely unable to tap the pool of shares held by insiders, and they trade mostly among themselves, with some shares also bought from other outsiders (domestic companies and banks). Managers do not seem to be selling at all, and workers are seen as largely inactive or only moderately active sellers.

TABLE 21

SHARE ACQUISITIONS BY FUNDS FROM OTHER SHAREHOLDERS

TYPE OF SHAREHOLDER	VERY ACTIVE IN SELLING SHARES	MODERATELY ACTIVE	NOT ACTIVE OR GENERALLY UNWILLING TO SELL
OTHER VOUCHER FUNDS	50.8%	31.1%	18.1%
DOMESTIC COMMERCIAL ENTITIES	22.1%	33.6%	44.3%
WORKERS	21.3%	32.8%	45.9%
BANKS AND OTHER FINANCIAL INSTITUTIONS	13.1%	25.4%	61.5%
DOMESTIC INDIVIDUAL INVESTORS	12.3%	40.2%	47.5%
MANAGERS	2.5%	3.3%	94.3%
FOREIGN INVESTORS	.8%	2.5%	96.7%

The obstacles encountered by the funds are particularly serious when they attempt to increase stakes in companies in their portfolios (see Table 22). Interestingly enough, cash constraints to increasing stakes are cited by only 43.5 percent of the funds. Indeed, even this number is misleading because the cash-poor funds are smaller than the rest (in terms of size, measured by the number of vouchers collected, they amount to 20.1 percent of all the funds), while larger funds, perhaps as a result of ties to other financial institutions or because of gains made in voucher trading, seem to have much more cash than is often believed. But the funds cite other difficulties to increasing stakes, with 47 funds (43.5 percent of all who attempted to increase stakes) reporting that management's efforts to prevent workers from selling is among the most important barriers. In addition, 27.8 percent report that management (illegally) refuses to register transfers of shares to outsiders, and 22.2 percent claim that the market they trade in is controlled by the management.

TABLE 22

OBSTACLES TO INCREASING STAKES

DIFFICULTIES EXPERIENCED BY THE FUNDS IN ATTEMPTING TO INCREASE THEIR STAKES	PERCENTAGE OF FUNDS AMONG THOSE WHO ATTEMPTED TO INCREASE THEIR STAKES
FINANCIAL DIFFICULTIES	
GENERAL LACK OF CAPITAL	43.5%
OUTSIDE INVESTORS DRIVE UP SHARE PRICES	32.4%
OTHER DIFFICULTIES	
MANAGEMENT PREVENTS WORKERS FROM SELLING	43.5%
EMPLOYEES ARE UNWILLING TO SELL	33.3%
OUTSIDE INVESTORS ARE UNWILLING TO SELL	29.6%
MANAGEMENT REFUSES TO REGISTER SHARE TRANSFERS IN THE SHAREHOLDER REGISTER	27.8%
MANAGEMENT OR MANAGEMENT CONTROLLED ENTITIES CONTROL MARKET	22.2%

The question of managerial coercion as a factor in preventing workers from selling their shares deserves a closer examination. As noted earlier, the architects of the Russian program very much hoped that most workers would sell quickly their shares in order to cash in on the large premiums resulting from the fact that they had acquired them nearly without payment. This, in turn, was supposed to have allowed more outside investors to come in as shareholders, and to mitigate the insider domination of privatized firms following on the heels of politically motivated concessions at the design stage.

As we have seen, the hoped for quick sell-off is clearly not happening (although there is some evidence of more modest selling activity). The usual explanation is the one that the funds give in their responses: workers are not selling because managers are making it impossible for them. Anecdotal and other evidence indicates that although formal voting-trust arrangements are rare, managers in fact not only use their power to persuade but also coerce workers not to sell by threatening dismissals of those who defy them as well as controlling the shareholder register and illegally threatening not to record ownership changes resulting from insider sales.[63]

To the extent this story is correct, one could expect perhaps that better protection of minority rights, especially enforcement of basic rules concerning voting and share registration, might "emancipate" the workers, who are collectively the largest shareholders in nearly every Russian firm, and put them in a better position to sell their shares. To be sure, such enfranchisement might also bring greater worker participation in the governance of privatized enterprises -- which most observers do not find an attractive prospect -- but the level of worker organization required for an effective exercise of worker control might not be present.

It seems, however, that while the story of managerial coercion is certainly a part of the picture, it is most likely not the whole story either. For in fact, managerial coercion, which might be hard to explain, given the relatively low levels of managerial ownership, might simply function to organize the workers and help them overcome collective action problems that they face in achieving objectives they desire independently

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[63] A special presidential decree (Presidential Decree No. 1768 of 27 October 1993, On Strengthening Shareholder Rights) was issued to curtail these kinds of abuses. Among other provisions, it required companies to release the control of their shareholder registers. But, as reported by Kommersant weekly (No. 7 of 28 February 1995 p. 42), a study, sponsored by the newly formed Russian Securities and Exchange Commission, on shareholder registration in the 3,400 largest open joint stock companies found that 44% of the companies have held on to their shareholder registers. Moreover, companies have proved quite inventive in requiring a number of documents with and without notarial certification as a prerequisite to registering a new shareholder.

of managerial coercion. Assume that the workers are primarily interested in the security of their employment and that the managers are primarily interested in retaining their control, which they can do by preventing the workers from selling their shares and making sure that the shares are voted for the management. But in this case, the managers also have a clear interest in the security of their workers' employment, since once the workers leave the company, they are much more likely to sell their shares. By the same token, the employees also have an interest in not selling their shares, since that keeps the management interested in keeping them employed. But unless the management fires those workers who actually sell their shares, the workers face a free rider problem, since cash-strapped individuals may try to cash in on their premiums. If many do so, the interest (and, to the extent outsiders come in as new buyers, the power) of the management in maintaining employment diminishes. Managerial coercion may thus simply come in to enforce an implicit (or even explicit) agreement among the workers to refrain from selling.[64]

If this account of managerial coercion is accepted, then measures intended to protect minority rights, even if enforced, are not likely to be fully effective, and formal voting trusts may become more common.[65] A more likely engine of change may be a decisive hardening of budget constraints of privatized enterprises and an increasingly

[64] The fact that 33.3 percent of funds cite that "workers are unwilling to sell," in addition to all the reasons relating to managerial coercion (see Table 22), may be an indirect confirmation of the independent employee interest in maintaining a high level of insider ownership.

[65] Forbidding such trusts, which would leave workers without legal means of enforcing their collective action decisions, might have some effect. But then it might also increase the pressure for extralegal enforcement mechanisms.

competitive environment that may come as a result of firmer macroeconomic policy. If a tough macro policy were to be sustainable over a long enough period of time, even in the face of increasing pressure from enterprises for renewed support, it may force the privatized firms to lower their costs and increase their need for new capital. This, in turn, may lead management, despite its desire to maintain control, to issue new shares to outside investors and to lay off workers, who will then become outsiders (as well as probably be willing to sell their shares to more active investors). Until such changes occur, the insider domination of Russian firms is likely to persist.

There is, however, evidence in our survey that the funds *are* trying to increase their stakes on the secondary market, and that they are quite successful in doing this. Thus, 75 percent of the funds in our sample attempted to increase their stakes in at least some companies in their portfolios: including overlaps, the number of the companies involved was 1,096, and the funds' success rate in increasing their stakes was 79.5 percent.

In order to sort out why, despite the numerous difficulties they cite, voucher funds can nevertheless report such high rates of success in expanding their stakes, we specified an equation modelling the impact of various factors on the success rate of the funds in increasing their original stakes on the secondary market (see Table 23).

TABLE 23

SUCCESS IN INCREASING STAKES THROUGH PURCHASES ON THE SECONDARY MARKET

EXPLANATORY VARIABLES	DEPENDENT VARIABLE NUMBER OF COMPANIES IN WHICH THE FUND INCREASED ITS STAKE BY BUYING SHARES ON THE SECONDARY MARKET[1]
NUMBER OF COMPANIES IN THE FUND'S PORTFOLIO	.04 (.03)
DUMMY VARIABLE #1: =1, IF OTHER FUNDS ARE ACTIVE SELLERS [2]	2.36[3] (.09)
DUMMY VARIABLE #2: =1, IF WORKERS ARE ACTIVE SELLERS[2]	1.65 (.17)
R-SQUARE	.55
NUMBER OF OBSERVATIONS	56

[1] OLS ESTIMATES; P-VALUES IN PARENTHESES

[2] =0, OTHERWISE

The model shows quite clearly that, overall, the funds are able to increase their stakes because they trade with other funds. Indeed, the significance of the funds' trading activity for the ability to increase stakes is the only one that remains, regardless of the impact of trading by any other groups listed in Table 21: even though our equation included dummy variables for the selling activity of these groups, their impact (which we did not report in Table 23) was insignificant. In particular, the impact of workers' selling their shares is overall insignificant as well -- indeed, it is probably even less important than Table 23 might suggest, because the workers' trading is not clearly separated from trading by the funds. When dummy variable #2 is split into two complementary components -- the first defined as taking the value of 1 whenever workers are active sellers and the funds are not, and the second as taking the value of 1 whenever both the funds and workers are active sellers -- the coefficient for the former becomes still smaller (.91) and the significance level drops even further (p-value: .49). The selling by the workers is significant (coefficient: 5.0; p-value .08) only in those very few cases (5.7 per cent) in which the funds are not active sellers -- a negligible impact overall.

The picture that emerges from this model is, again, one in which the hoped-for sell-off by the insiders is not taking place. But independently of any flow of shares from insiders to outsiders, an important reallocation of holdings does take place among the funds themselves, and this factor probably contributes to the strengthening of the funds' overall position. Indeed, the extent to which funds seem to be able to "trade upwards" into a position of being the largest shareholder is quite amazing: as shown in Table 24, which models the determinants of the funds' ability to become the largest shareholders of companies in their portfolios, every successful attempt by a fund to increase its stakes increases by over 40 percent the chances that the fund will also become the largest shareholder in one of the companies in its portfolio. (The success in increasing stakes also drives out all other potential explanatory variables in the equation reported in Table 24.) Given the concentration of ownership in Russian companies, in which management and the state always hold significant stakes, and the generally low levels of liquidity, the reallocation of influence that takes place through trading among the funds looks very impressive. To be sure, we have seen (in the previous section) that this influence is far too modest to amount to control; nevertheless, the consolidation of holdings shows that trading does contribute to the strengthening of the voucher funds' position in corporate affairs.

TABLE 24

CHANGES IN THE FUNDS' OWNERSHIP STAKES THROUGH PURCHASES OF SHARES ON THE SECONDARY MARKET

	DEPENDENT VARIABLE
EXPLANATORY VARIABLES	NUMBER OF COMPANIES IN THE FUND'S PORTFOLIO IN WHICH THE FUND IS THE LARGEST SHAREHOLDER[1]
TOTAL NUMBER OF COMPANIES IN THE FUND'S PORTFOLIO	.03 (.02)
NUMBER OF COMPANIES IN WHICH THE FUND INCREASED ITS STAKE BY BUYING SHARES ON THE SECONDARY MARKET	.42 (.0001)
R-SQUARE	.54
NUMBER OF OBSERVATIONS	57

[1] OLS ESTIMATES; P-VALUES IN PARENTHESES

3. The determinants of the funds' trading activity

If trading among voucher funds is an important factor in a reallocation of holdings among the voucher funds, what makes a fund engage in trading as an important part of its activities, rather than concentrating on maximizing the value of its portfolio through the exercise of voice in company affairs or simply passively holding on to its shares? Why is it that such a significant proportion of funds (57 percent) report that they are or have been at some point in the past "actively trading shares on the secondary markets"? We have already hypothesized that, despite the low levels of liquidity among Russian companies, so many funds become involved in trading because their attempts to become active shareholders in the companies in their portfolio are blocked by the insider domination of Russian companies, and that the incentive to trade has been additionally strengthened by the high profits which many traders realized by selling the companies acquired at very low prices during the initial voucher auctions.

The estimates of a logistic equation modelling the determinants of a fund's decision to engage in active trading, which are presented in Table 25, generally confirm our conjectures. The model shows that the decision to engage in active trading is essentially a function of four different factors: (1) the fund's alliance with management of companies in the fund's portfolio, (2) the ability of the fund to engage in shareholder activism (as measured by the number of board seats obtained by the fund), (3) the number of traded companies in the fund's portfolio, and (4) the fund's ability to make large profits by selling a block of shares of one or more companies in its portfolio. Of these explanatory variables, the last two have a positive impact on the probability that a fund will engage in active trading, and the first two have the opposite (negative) effect.

TABLE 25

DETERMINANTS OF A FUND'S DECISION TO ENGAGE IN ACTIVE TRADING

	DEPENDENT VARIABLE
EXPLANATORY VARIABLES	PROBABILITY THAT THE FUND HAS BEEN ACTIVELY TRADING SHARES ON THE SECONDARY MARKET[1]
NUMBER OF COMPANIES IN THE FUND'S PORTFOLIO FOR THE FUNDS WHICH REPORT THAT THE MANAGEMENT IS AMONG THEIR TOP THREE ALLIES	-.03 (.02)
NUMBER OF COMPANIES IN WHICH THE FUND IS REPRESENTED ON THE BOARD OF DIRECTORS	-.07 (.12)
NUMBER OF COMPANIES IN THE FUND'S PORTFOLIO WHICH ARE TRADED	.15 (.05)
FOR THE FUNDS THAT REPORT THEY WERE ABLE TO MAKE LARGE PROFITS FROM SELLING A BLOCK OF SHARES	.15 (.03)
LIKELIHOOD RATIO STATISTIC[2]	23 (.0004)
ASSOCIATION OF PREDICTED AND OBSERVED PROBABILITIES	84%
NUMBER OF OBSERVATIONS	59

[1] MAXIMUM LIKELIHOOD ESTIMATES OF LOGISTIC EQUATION; ASYMPTOTIC P-VALUES IN PARENTHESES

[2] CHISQUARE WITH COVARIATES

Although the p-value for the negative correlation between board seats and a decision to engage in active trading is borderline, the coefficient is quite high: for each company in which a fund has a board seat, the fund is 7 percent less likely to trade actively in any companies in its portfolio (and not just the company in which it is represented on the board). This seems to show that shareholder activism has a very strong pull as an overall portfolio management strategy, and that the strength of the obstacles to activism (voice) is indeed responsible for the funds' decision to trade (exit).

Another, to some extent related portfolio management strategy that dampens the funds' propensity to trade is their widespread promanagerialist attitude. Given that most Russian companies are both illiquid and insider- (particularly management-) dominated (with the two phenomena being obviously related), most funds, as we have seen (Table 17), try to ally themselves with the management of the companies in their portfolios. Some of the funds adopting this strategy, especially those that had privatized companies among their founders, may have started out as "managerialist"; others may have simply adopted this attitude because they came to be locked into very illiquid portfolios and learned that they had no other viable option. One way or the other, however, management-friendliness, like shareholder activism,[66] seems to be an overall portfolio management strategy, so that an addition of a nontraded company to a fund's portfolio *lessens* the chance that the fund will engage in active trading in *any* of the companies in which it is invested.[67]

The most direct constraint on trading activity in Russia results, of course, from the limited liquidity of the securities market: on the average, under 25 per cent of the companies in the funds' portfolios are traded at all, and most of those trade locally and

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[66] Although our model indicates that the two are distinct factors, they may, of course, be closely related under the very special Russian conditions -- it is enough to remember that most funds list cooperation with management among the most important factors in obtaining a board seat.

[67] This effect dissipates after a threshold of portfolio liquidity is reached: when the proportion of traded companies in a fund's portfolio reaches some 20 percent ([x] percent for funds that also made large profits from trade), further addition of illiquid companies no longer decreases the fund's propensity to trade. For funds that do not list management among its allies, the addition of a nontraded company has no significant effect on trading activity.

irregularly (see Table 20). Since the funds had a very limited ability to pick liquid companies to begin with (it was not even known, at the time of most voucher actions, which companies would trade on the secondary market), many ended up with portfolios that were sufficiently illiquid to discourage them from the initial investment necessary to develop a capacity to engage in active trading. But the model shows that a very small number of traded companies in one's portfolio is necessary for non-management-friendly funds to begin active trading: the addition of just four liquid companies increases the probability of becoming an active trader by 60 percent. (Even for management friendly funds, the addition of only five liquid companies has the same effect.) What this means, among other things, is that engaging in any sort of trading leads very quickly to becoming an "active" trader: since shares of companies acquired on the secondary market are, by definition, traded, just a few such acquisitions are enough to move one up into this category.[68]

Finally, the initial undervaluation of shares at the voucher auctions seems to have given a tremendous boost to trading activity in Russia. As the model shows, the mere fact of having made significant profits from a sale of a block of shares of one or more companies in one's portfolio is enough to double the already high impact of the addition of one traded company to one's portfolio, bringing it to 30 percent. In practice, having

[68] The concept of "active trading" was not defined in the questionnaire: the funds were simply asked whether they were "actively trading shares on the secondary market." It is possible, therefore, that the funds perceive themselves as "actively trading" at a lower level of activity than would be normal in another environment. (It is also possible that the funds' responses were shaped by an environment of mid-1994, in which trading was much less common. At the initial voucher auctions, when the funds could not really predict which shares would become liquid, one needed to acquire, on average, 20 companies to increase by 5 the number of traded companies in one's portfolio -- a very significant number, given that the median number of companies per fund in the sample is 35.

made large profits from cashing in on the premiums resulting from the initial undervaluation of the Russian companies is, by itself, nearly enough to make a fund engage in "active trading."

VI. LARGE FUNDS

The overall size distribution of Russian voucher funds, as measured by the number of vouchers invested,[69] resembles a pyramid with a few very large funds at the top and many small and medium-size funds filling in the rest. Indeed, the largest fund (First Voucher Fund) is twice as big as the second and the third, and these two are more than twice as big as the fourth largest fund. Only below the 500,000-voucher level does the field become somewhat more densely populated. (See Table 26.)

[69] See Table 3, above.

TABLE 26

SIZE OF THE LARGEST FUNDS

TOP TEN FUNDS IN THE SAMPLE	NUMBER OF VOUCHERS INVESTED
LARGEST	4,000,000
SECOND LARGEST	2,000,000
THIRD LARGEST	1,880,000
FOURTH LARGEST	800,000
FIFTH LARGEST	551,185
SIXTH LARGEST	512,000
SEVENTH LARGEST	500,000
EIGHTH LARGEST	450,000
NINTH LARGEST	397,000
TENTH LARGEST	395,000
TOTAL NUMBER OF VOUCHERS INVESTED BY THE TOP TEN FUNDS	11,485,185
AS PERCENTAGE OF TOTAL COLLECTED BY ALL FUNDS IN THE SAMPLE	56%

Beyond the top ten funds, the 36 largest funds, constituting the first quartile of our sample, invested 83.1 percent of all the vouchers in the sample. These funds also have, on average, significantly more companies in their portfolios: 69.9 for the funds in the first quartile; 42.3 for the remaining funds (p-value: .02).[70]

[70] According to an estimate obtained from a regression on the number of companies and the number of vouchers, every time a fund invests additional 100,000 vouchers, additional 2 companies are added to its portfolio. But the differential in the number of companies held by the large and small

The large funds, including the few giants at the top, deserve special attention. Their very size makes them into a potentially very powerful force on the Russian economic scene. But in addition to their economic significance, they are also important from the political point of view. If, for example, the large funds were to turn out to be more management-friendly or more oriented toward rent-seeking than the rest, they might be quite effective in organizing a powerful lobby to protect the entrenchment of insiders or to keep the state in the business of dispensing its largess. Indeed, these funds might replace the old industrial associations (the elimination of which was among the main objectives of the voucher program) and help the companies they hold overcome the collective action problems they now face in lobbying the government for continued subsidies and other forms of support. Moreover, large funds, locked into their holdings in many nonviable production companies, might make it more difficult to close down the nonperforming industrial albatrosses, since any attempts at such retrenchment would involve not only laying off many thousands of workers, but also bankrupting the large funds with millions of shareholders. On the other hand, if the large funds are likely to bet on the economic success of their companies, they might become the leading agents of restructuring and supporters of further reform.[71]

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funds is much smaller than that in the number of vouchers: the large funds hold 83 percent of the vouchers, and only 36 percent of the companies in the funds' portfolios. Even correcting for the fact that, on average, they also hold larger stakes (see below), the bigger funds seem to have invested in much more expensive companies. Whether their participation in voucher auctions bid up the share prices or whether they concentrated on more valuable companies (or both), we were unable to determine.

[71] For a discussion of the political economy of privatization investment funds, see Frydman and Rapaczynski (1994), especially ch. 6.

In order to get an overview of the character of the large funds, we have compared them to the rest of the sample along most dimensions discussed in this paper. The results of these comparisons are presented in Tables 27 through 29, which list all cases in which the differences were statistically significant.

The overall picture of the large funds, which emerges from our comparisons, is quite reassuring. The large funds, as investors, have significantly more cash (Table 29), better access to information (Table 27), and more sophisticated criteria of choosing the companies for their portfolios (Table 27). In picking their companies, they look much less at the notoriously unreliable profitability figures, concentrating instead on such fundamentals as the quality of equipment, access to non-state sources of credit (indicating financial soundness), and business connections to other companies in their portfolios. (To be sure, this last criterion may also be a sign of recreating old vertical interenterprise connections, but such an interpretation is unlikely in light of the other characteristics of large funds. Instead, looking at business connections as a criterion for investment is more likely an effort to capitalize of the funds' expertise in certain areas or an attempt to exploit potential synergies among the companies in one's portfolio.)

TABLE 27

LARGE FUNDS: INVESTMENT CRITERIA AND ACCESS TO INFORMATION

INVESTMENT CRITERION	VERY IMPORTANT[1]		NOT IMPORTANT		P-VALUE
	LARGE FUNDS	ALL OTHERS	LARGE FUNDS	ALL OTHERS	
QUALITY OF PRODUCTION EQUIPMENT	47.06	47.31	0	12.9	.07
PROFITABILITY	41.2	74.2	8.8	4.3	.00
BUSINESS CONNECTIONS WITH OTHER COMPANIES IN THE FUND'S PORTFOLIO	44.12	33.3	17.7	35.5	.09
EXPECTED COOPERATION WITH MANAGEMENT TO OVERCOME EMPLOYEE RESISTANCE	17.7	38.7	32.4	29.0	.06
ACCESS TO NON-STATE SOURCES OF FINANCE	14.71	10.8	44.1	66.7	.06
ACCESS TO FINANCIAL INFORMATION	**LARGE FUNDS**		**ALL OTHERS**		**P-VALUE**
FUNDS WITH REGULAR ACCESS TO FINANCIAL DATA IN ALL OR MOST OF THE COMPANIES IN THEIR PORTFOLIOS	66.7		45.6		.03
ADDITIONAL INFORMATION AVAILABLE ALWAYS UPON REQUEST (VERSUS RARELY OR NEVER)	64.0		43.6		.08
PERCENTAGE OF FUNDS MONITORING THE COMPANIES IN THEIR PORTFOLIOS BY MEANS OTHER THAN BOARD PARTICIPATION	91.7		71.6		.01
MEANS BY WHICH FUNDS MONITOR COMPANIES IN THEIR PORTFOLIOS					
REVIEW OF FINANCIAL DATA	91.4		69.5		.01
INFORMAL SOURCES	89.7		65.5		.01
SHARE PRICES	88.0		65.5		.03
VOLUME OF OUTPUT	85.7		58.6		.02

[1] Percentage of funds listing each criterion as being in the "very important" category. Number of valid responses for every row of this table is 127.

Once large funds invest in a company, they are much more likely to keep well informed about it. They manage to obtain financial data of most companies in their portfolios,[72] and uniformly use all available means to supplement the information provided by the management with that obtained from other sources. Perhaps most encouragingly, large funds are both more active as shareholders and less management-friendly than the other funds.

[72] The ten largest funds are even more successful than the rest: all of them report regular access in all or most of their companies.

TABLE 28
DATA PERTAINING TO THE ACTIVISM OF LARGE FUNDS

	LARGE FUNDS	ALL OTHERS	P-VALUE
AVERAGE STAKE HELD	9.35	6.0	.00
AVERAGE PERCENTAGE OF COMPANIES IN A FUND'S PORTFOLIO IN WHICH THE FUND IS THE LARGEST SHAREHOLDER	14.2	7.1	.08
AVERAGE PERCENTAGE OF COMPANIES IN A FUND'S PORTFOLIO IN WHICH THE FUND IS REPRESENTED ON THE BOARD	23.7	14.2	.02
	PERCENTAGE OF FUNDS		
COMPANIES IN THE FUND'S PORTFOLIO IN WHICH THE FUND IS AN ACTIVE INVESTOR[1]			.00[2]
NONE	5.6	25.2	
SOME	63.9	65.05	
MAJORITY	27.8	7.8	
ALL	1.9	2.8	
PERCENTAGE OF FUNDS WHICH ATTEMPTED TO INCREASE THEIR INITIAL STAKES	86.1	70.1	.07
AVERAGE PERCENTAGE OF COMPANIES IN A FUND'S PORTFOLIO IN WHICH A FUND ATTEMPTED TO INCREASE ITS STAKES	28.6	15.4	.02
TYPES OF SERVICE PROVIDED BY A FUND			
INVESTMENT EXPERTISE	76.5	58.2	.06
EXPERTISE IN RESTRUCTURING OR REORGANIZING THE COMPANY	67.7	46.8	.04
ARRANGING ACCESS TO FOREIGN CUSTOMERS	38.2	16.7	.01
ARRANGING ACCESS TO FOREIGN SUPPLIERS	29.4	15.4	.09
ARRANGING ACCESS TO CREDITS			
ACCESS TO DOMESTIC NON-STATE CREDITS	55.9	35.4	.04
EXTENDING CREDIT TO COMPANY	29.4	13.8	.05
ACCESS TO STATE CREDITS	23.5	11.4	.1
ATTITUDES TOWARD OTHER SHAREHOLDERS AS ONE OF THE THREE MOST COOPERATIVE SHAREHOLDERS			
MANAGEMENT	56.7	70.7	.09
VOUCHER FUNDS	53.1	68.5	.08
FOREIGN FINANCIAL INVESTORS	18.8	7.6	.07
FOREIGN TRADE INVESTORS	9.4	2.1	.08

[1] A fund is considered to be an "active investor" if it spends significant resources and/or effort on monitoring and/or influencing major decisions, such as employment, investment, structure of production, sales, organization, etc.

[2] P-value for the test of (NONE OR SOME) versus (MAJORITY OR ALL).

The activism of large funds manifests itself in a variety of ways. Even correcting for their larger portfolios, they are represented on many more boards of directors, and they are more likely to provide a large array of services to their companies. What may be of particular importance in Russia, they seem to be among the very few institutions with foreign connections and they often report making those connections available to the companies in their portfolios.

The enhanced shareholder activism of large funds has several explanations. These funds are bigger and richer, and they are more likely to be able to afford the significant costs involved in monitoring. They also hold, on average, significantly larger stakes and are much more often the largest shareholders in their companies (Table 28), which gives them more power to make their influence felt. Perhaps most importantly, their very size is likely to have resulted in their acquiring rather large stakes in many illiquid companies. It must be remembered that the large funds often had a huge number of vouchers which they had to invest in a very short period of time,[73] and the nature of the supply simply did not allow them very much choice. Once such funds acquired their portfolios they were probably largely locked in and had no other option but to try to maximize their value by becoming actively involved. This explanation is further confirmed by the fact that large funds are not particularly active traders, except for attempts to increase stakes in the companies in which they are already invested.

[73] Vouchers were originally to expire at the end of 1993 after only slightly more than 12 months. However, a presidential decree issued in October 1993 extended this deadline until July 1, 1994. See Presidential Decree No. 1591 of 6 October 1993.

TABLE 29

OBSTACLES TO INCREASING STAKES

DIFFICULTIES EXPERIENCED BY THE FUNDS IN ATTEMPTING TO INCREASE THEIR STAKES	PERCENTAGE OF FUNDS AMONG THOSE WHO ATTEMPTED TO INCREASE THEIR STAKES		P-VALUE
	LARGE FUNDS	ALL OTHERS	
FINANCIAL DIFFICULTIES			
GENERAL LACK OF CAPITAL	22.2	49.5	.00
OTHER DIFFICULTIES			
MANAGEMENT REFUSES TO REGISTER SHARE TRANSFERS IN THE SHAREHOLDER REGISTER	30.6	18.5	.08

Equally interestingly, large funds are significantly less management-friendly than the rest. They list management much more rarely among their top three corporate allies,[74] they cite much less often their connections to management as a reason for investment, and they report greater management hostility toward them, particularly the frequency with which management tries to prevent them from increasing their stakes by refusing to register share transfers in the shareholder register. Consequently, their shareholder activism may be of particular importance for the improvement of the performance of the companies in their portfolios.

VI. Concluding Remarks

[74] It is perhaps worth noting that the large funds' attitude toward management seems to be quite bipolar. Thus, among the top ten funds, five list management as their No. 1 ally, while none of the rest list it among their top *three* allies.

Filling the gap created by the withdrawal of the state from the commanding position of control over the industry in Eastern Europe has constituted one of the most challenging problems of transition to an efficiently functioning market economy. Beyond many difficult conceptual and implementation problems, a massive transfer of assets in Russia and other East European countries has often required political support from enterprise insiders (managers and workers). While granting substantial benefits to the insiders has softened their resistance to privatization and has very likely been crucial for a speedy transfer of assets from the state, Russia stands out as an example of how such *ex ante* political concessions may weaken the effectiveness of post-privatization corporate governance mechanisms and delay the badly needed enterprise- and economy-wide restructuring. The future of the Russian economy depends largely on whether new outside owners, among whom voucher privatization funds studied in this paper are potentially the most important, will be able to effect substantial improvement in the allocation of resources often opposed by the insider owners. Our results show that although there are hopeful signs, Russia still has a long way to go before the privatization experiment accomplishes its ultimate objectives.

APPENDIX: Methodological Note

A number of tables in the paper report the results of estimation of a series of relationships among a subset of variables measuring various aspects of funds' activities, particularly those related to trading and shareholder activism. We confine our multivariate statistical analysis to single-equation models. This may ignore simultaneity problems in some cases, but we believe that these problems are not serious. The models are estimated on the basis of a complete subsample of 59 to 69 respondents with nonmissing answers to survey questions concerning variables included in the estimated models. The use of this subsample in the estimation does not seem to introduce any apparent bias, since the relative frequency distributions of key characteristics, such as the size of funds or the number of insider-dominated companies in their portfolios, are very similar in the subsample to the distributions of the same characteristics in the whole sample of survey responses (148 funds).

We estimated two types of models: regression models and logistic equations. To avoid data mining, we tried to estimate the most parsimonious and simplest specifications motivated by clear prior theoretical considerations. Products of variables, including interactive dummies, were included only if they were thought to capture an important aspect of the estimated relationship. Such interactive variables and other products often turned out significant and provided some of the more interesting interpretations of the survey responses.

The reported equations include only variables which turned out to be significant.

Whenever an interactive dummy was used, the complement was also tested, and if it is not presented, it turned out to be insignificant.

We also tested the overall fit of the estimated equations. For regression models this involved a conventional F-test and an examination of the stability of coefficients of retained variables when other variables were added to the equations. We examined studentized residuals to detect outliers and other specification problems. The reported equations seem free of any serious misspecifications.

For logistic equations, we were forced to rely on asymptotic likelihood ratio tests. These were supplemented by an examination of the Akaike Information Criterion and various measures of association between the predicted and observed probabilities. We also looked at the stability of estimated coefficients in the presence of additional variables. The selected models were superior to the rest according to a number of these criteria, and seem to provide a good fit to the data.

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