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Enforcement of Corporate Governance Rules

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Session 1: Recent Developments and Future Reforms

Corporate Governance in Azerbaijan: Recent Achievements
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Dear Ladies and Gentlemen!

I would like to extend my gratitude to organizers for the opportunity to make a speech at this excellently designed event and brief participants on recent developments in Azerbaijan in the area of Corporate Governance and cover 3 issues: progress, problems and priorities. As I have limited time for my speech I will try strictly to concentrate on those 3 Ps.

As it was reported in the last meeting in Kyiv in May 2004, Law on Securities and Law on Joint Stock Companies (JSC) were incorporated to the Civil Code (CC) and in April 2004, Milli Mejlis (The Parliament) adopted the Code in new edition with significant amendments relating to corporate governance practices. Some of them deserve to be mentioned.

Thus, any transaction with a sum exceeding 25% of the total value of the assets of a corporation is recognized as a transaction of special significance and in that regard the decision to permit that transaction should be made at the General Meeting and information on that should be disclosed¹. Another article says that an Issuer may provide preemptive rights to the existing shareholders². It means that the existing shareholders receive the rights to purchase first the new emission in proportion to their stakes. The next Article³ prescribes that JSCs should conduct all their IPOs through the stock exchange. In the part “Transaction with securities” there is an article⁴ that JSCs with more than 100 shareholders should conduct all transactions in the secondary market except direct sale through the stock exchange. But there is no description what is a direct sale in the current legislation, which allows counterparts to avoid the open market and jeopardize the basic principles of corporate governance standards. Also a corporation with more than 20 shareholders should engage an independent registrar⁵ for register keeping purposes. The latter is a specialized licensed professional activity. There are norms, which assist in the General Meeting arrangements like proxy voting and in absentia⁶. Precise procedure should be described in the corporation Charter. The requirement to disclose any material information, which could impact on economic\financial activity of the Issuer⁷ should definitely be counted as a step towards transparency support. Those are some provisions from CC showing that there is a basic environment for promotion market transparency and good corporate governance practices in Azerbaijan.

Traditionally the banking sector in Azerbaijan is the most developed in comparison with other sectors and we are used to see that they first experience all innovation in the market. The same is true with corporate governance. The National Bank of Azerbaijan (NBA) adopted in November 3, 2004 the Rules on Implementation the Corporate Governance Standards in the Banks. The Rules are to implement high corporate governance standards in the banks, and define the base for organizational structure, activity and corporate behavior in the

¹ (CC, Article 99.3)

² (CC, Article 1078-15.5)

³ (CC, Article 1078-15.6)

⁴ (CC, Article 1078-20.9)

⁵ (CC, Article 106-2)

⁶ (CC, Article 107-3)

⁷ (CC, Article 1078-43)

banks. The Standards also require the shareholders and executives of a bank to clearly understand, develop and implement the following: strategic planning process, rational organizational structure, financial planning process, internal control and reporting system, disclose clear, accurate and unbiased information, risk management system, management information system, protect the interest of related parties and stakeholders, internal regulation to assure reporting system according to IFRS, etc. There were definitions introduced first time like fiduciary obligations, related parties, related interests, etc.

Late in 2004, the State Securities Committee adopted two regulations, which really could be counted as progressive steps towards providing fair, transparent and equal conditions for market participants. Those are Rules on storage, usage and submission of service (inside) information in the securities market⁸ and Rules on preparation of annual reports by the issuer of investment securities and its disclosure⁹. The former defines an Issuer's Supervisory or Executive Board members, any entities owning at least 10% of issuer's charter capital, etc as insiders and restrict and regulate their activity. So, insiders are prohibited to conduct operation with the use of service (inside) information and instigate others to conduct operations using service (inside) information.. There are also points for disclosure of such kind of operations and it should contain date, place, purpose, counterparts, the name of issuer, price, volume and other parameters of securities. The latter prescribes JSCs to prepare annual reports which should contain the recent changes in the organizational structure, ownership, legal form, subsidiaries, management, new emissions and their details, the registers, the list of legal entities (name, address, Tax ID and stake in the capital) with 10% and more ownership in the charter capital, etc. It also should be noted that the SCS has authority to impose sanction and fees for any violations according to the Administrative Code.

In terms of providing equal and fair access to the capital there is a norm that any Issuers should wait for 15 days after the disclosure of Prospectus.¹⁰

Baku SE in conjuncture with IFC Azerbaijan Corporate Governance Project started to revise the listing rules mostly emphasizing corporate governance standards. For example, the thing like existing of Audit and Remuneration Committees, Independent director(s), etc. should be prerequisites for the 1st tier listing. Of course we understand well that we also should think about how to encourage the companies through open market, like tax incentive for listed shares and/or access to resources (Kazakhstan case); in that field we closely work with the SCS and international institutions to promote our suggestions further among related government agencies.

In order to understand where the difficulties lie let me give you some background information. Since the privatization has started in Azerbaijan in 1996 around 1600 state owed companies have been transformed into JSCs. Over the time we are observing a huge concentration of shares in one or group of shareholders who are afraid to lose control over the company. Those group of people owning approximately 70-90% of capital are not interested in openness and accountability, setting a fair market price for the shares or protecting the minorities' rights. Obviously these few but very powerful people impede the corporate governance practices.

⁸ (Dated 5th November, 2004)

⁹ (Dated 29th December, 2004)

¹⁰ (SCS, Rules on equity emission to increase charter capital of JSC, dated November 30, 2004)

As SCS reports, during 2005 it received 334 official complaint letters relating to 550 JSCs. Investigations discovered that there were law violations in 132 JSCs and they all were fined. Besides, 61 JSCs received official notifications to fix the shortcomings. As figures show, in most cases like 60%, those violations concerned the disclosure requirements, and the rest – violations of shareholders rights, presumably minorities.

With the regard to capital market development should say that we had market growth in 6 times in 2005. On one hand, this makes us happy, as we succeeded to generate more trades, around 600 million USD, but on the other hand, the fact that the corporate sector captures just 15% of that trade definitely frustrates us. In 2005, we had 42 IPOs (76 mln. USD) out of 102 share placements done by 84 issuers. Majority IPOs like 90% belongs to banks, as they have to raise their charter capital administratively due to National Bank instruction. The way to do that is IPO as all banks in Azerbaijan are JSCs. And we had 3 corporate bond IPOs by 3 issuers, which raised 4.1 mln. USD. The positive fact with that was that 2 of them were non-banking organizations offering approximately 13% interest to investors. I am not going to dig out figures, just want to say that enterprises in the country prefer short and expensive bank loans rather than cheaper and long-term stock market resources. Investors' point is that there are limited range of stock products, and the Issuers' point that we cannot make an interesting offer until no demand in the market. That is a double-edged sword. In that case, we believe that the Government should play a role of catalyst in terms of encouraging the capital market development. As international practice shows one efficient way to achieve that is to change the privatization mechanism making a part of state ownership available to wide public through the stock exchange like in China, Poland and other emerging markets. Analyzing the developments in the corporate sector and capital market I definitely should mention low equity culture and some time top managers skepticize what are real advantage promoting corporate governance practices.

Finally, in few words I would like to outline priorities based on above-mentioned issues. Obviously, education programs and public awareness campaigns are the must. When I say education I mean not only the academicians and practitioners but also the judges and other professional in the court as sometimes even they misinterpret current legislation on corporate and securities laws. In 2005 in conjuncture with IFC ACGP we announced a national essay competition encouraging people to focus on corporate governance problems, and the results nicely surprised us as it triggered a useful discussion with promising ideas. We definitely should continue that traditions. According to the new Accounting Law¹¹ all enterprises in Azerbaijan have to shift to IFRS by 2009. The Ministry of Finance which is defined as a central executive body to implement that Law identify a short list of the companies of public importance. That is mainly state owned enterprises like Azerenergy, SOCAR, Azerigaz, Baku metro, etc which are applied to IFRS fist by 2008. The implementation of that Law definitely will serve as a good practice for accountability and transparency. Another priority for us is privatization. I mean, in the eve of big privatization we expect the government decision to put a defined part of a state package to BSE listing. We, in turn should be ready with the new listing requirements encouraging companies and practicing good governance cases. Simultaneously we work closely with the government to foresee benefits for the listed companies. The Government does its best to reinforce Pension Reforms in the country and we have already started the shift to personal accumulation pension system. The State Social Protection Fund is also assigned to draft the regulation for Private Pension Fund's activity. SCS Committee is busy with revising current legislation on Investment Funds.

¹¹ (Came into the force in 2005)

All those give us a hope that there is a good base to develop collective investment institutes, which in turn could stimulate capital market development and encourage issuers to practice good corporate governance standards according to OECD principle, as they will understand well then that only those who meet those standards get access to the resources.

At the end I have one remark: I would like to suggest and think it would make sense if the next Roundtable was held in Baku with the involvement of major stakeholders. We definitely will support that initiative which I believe could raise the interest in the further development of corporate governance in Azerbaijan.

Thanks for your attention.