Capital Markets in Eurasia: Two Decades of Reform

- Expanded Second Draft -

Prepared for the Experts Meeting of the Eurasia Group on Corporate Governance for Capital Market Development

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For further information, please contact Mr. Daniel Blume, Project Manager (tel: +33 1 45 24 75 99, e-mail: Daniel.Blume@oecd.org) or Mr. Serdar Celik, Project Consultant (tel: +33 1 45 24 79 84, email: Serdar.Celik@oecd.org). Secretariat wishes to acknowledge the support of consultant W. Richard Frederick in the development of the second draft of this paper.
The Eurasia Group on Corporate Governance for Capital Market Development

The Eurasia Group on Corporate Governance for Capital Market Development brings together representatives of Eurasian governments and capital market authorities that are responsible for shaping and implementing corporate governance-related laws and regulations. It also involves stock exchanges and relevant private sector stakeholders. Key participating countries from the region include Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

The Group aims to:

(i) Address the link between capital market development and economic growth. Identify how better corporate governance practices can contribute to capital market development in Eurasia.

(ii) Create awareness in Eurasia of the role of corporate governance in capital market development through sharing of international best practices and knowledge with all relevant stakeholders. Create awareness outside of Eurasia about efforts and progress made in the region.

(iii) Suggest how existing policies, regulations and institutions can be improved to strengthen corporate governance and development of Eurasian capital markets;

(iv) Reinforce the capacity of Eurasian regulators to efficiently exercise their responsibilities.

The Group’s work builds upon initial work carried out by the Eurasian Corporate Governance Roundtable, organised by the OECD from 2000 to 2008, as well as other work on corporate governance and capital markets carried out by other regional and international institutions. In view of the fundamental role played by capital markets in economic growth, the conclusions of the Roundtable highlighted the need to empower regulators to enforce existing laws and rules and the important role of capital market authorities and stock exchanges in corporate governance issues, such as for the protection of minority shareholder rights, prevention of abusive related party transactions and insider trading.

The two major outputs of the Eurasian Roundtable process were the report, Corporate Governance in Eurasia: A Comparative Overview (2004), and the Policy Brief on Corporate Governance of Banks in Eurasia, developed jointly with the EBRD (2008). Both reports provided a detailed comparison and analysis of the corporate governance landscape in the Eurasia region.

The OECD in co-operation with other regional and international organisations will support the Group’s objectives through the review and consolidation of existing research in this field, analysis of current policy, regulatory and institutional frameworks, fact-finding and the organisation of policy dialogue involving OECD and Eurasian policy and regulatory representatives and relevant stakeholders.

This report and the work of Group have been generously supported by the Capital Markets Board of Turkey and the Istanbul Menkul Kiymetler Borsasi, for which they are thanked.
**Introduction**

1. Two decades have passed since the independence of Eurasian countries and their considerable efforts to develop their capital markets. The first decade started with a deep recession and hyper-inflation, and naturally focused on macroeconomic stabilisation and structuring of economic institutions to move to market economies. The capital market authorities, stock exchanges and other capital market institutions were mostly established during this period. With the support of international institutions, Eurasian countries had a significant opportunity to organise these institutions and market infrastructure in accordance with the practices of more developed financial markets. For instance, most countries in the region have established stock exchanges based on a private company model format.

2. Yet, all capital markets in the region are still at an early stage of development. They differ from each other in terms of market size, market participants and institutional and regulatory frameworks. In some countries there are no organised stock markets. Others have exchange or trade platforms with modest trade volumes. In addition, good examples of public disclosure platforms for listed companies, government bond markets, clearing and settlement systems and international co-operation also exist in the region.

3. Although capital markets in the region remain at a relatively early stage of development, their reform endeavours have been important. All Eurasian countries achieved high annual economic growth rates in the second decade of their independence, with an increasing role for securities markets. Indeed, Eurasian economies along with developing and emerging economies in other parts of the world represent an increasing share of global capital markets, especially in terms of total market capitalisation. The share among developing economies increased from 6% in 1990 to 10% in 2000, and reached 32% in 2010\(^1\). The share of market capitalisation of Eurasian capital markets, while small in relative terms, also increased sharply during this period, from 0.01% of total global market capitalization in 2000 to 0.19% in 2010. Although in different stages of development, Eurasian countries have all benefited from this global trend of shifting wealth\(^2\).

4. In addition, they have undertaken significant legal and institutional reforms with regard to corporate governance over these two decades, including commercial law and financial regulatory reforms. Most Eurasian countries have also introduced corporate governance codes for listed companies, as well as in some cases codes for special types of corporations such as banks. On the other hand, weak implementation and enforcement is still the case across the region.

5. The OECD Principles of Corporate Governance say that “corporate governance is one key element in improving economic efficiency and growth, as well as enhancing investor confidence.” This role of corporate governance in building investor confidence, as a *sine qua non* for capital market development, emphasizes the links between corporate governance, capital markets and economic growth. Considering the importance of good corporate governance for capital market development, this *Eurasia Group on Corporate Governance for Capital Market Development* has been launched to address the link between capital market development and economic growth, and to identify how better corporate governance practices can contribute to capital market development in Eurasia.

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\(^1\) In terms of total market capitalisation of local listed companies (see World Bank Development Indicators: http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS/countries?display=map).

\(^2\) Shifting wealth: refer to OECD’s Perspectives on Global Development 2010: Shifting Wealth
This paper is intended to provide background and issues for further reflection and focus for the second meeting of the Group, involving a smaller group of experts from participating countries, and to prepare recommendations for consideration at the plenary meeting of the Group to be held in November 2012. It builds upon the paper presented at the last meeting, which has been expanded to include the results of a survey of both Eurasian regulators and stock exchanges that was undertaken earlier this year. This data are supplemented with feedback gathered in interviews, which provided a more qualitative view on developments, as well as additional published materials.

**Box 1: OECD Survey of Eurasian Stock Exchanges and Regulators**

The OECD conducted a survey of Eurasian Stock Exchanges and regulators from 12 countries in the spring of 2012. The purpose of the survey was to conduct a stocktaking of corporate governance practices to better understand the relationship between corporate governance and the development of capital markets. Regulators were asked a series of questions on, among other things, what factors and institutions encourage better corporate governance, the legal framework, the role of boards, shareholder rights and disclosure and the independence of regulatory bodies. Stock exchanges were questioned regarding their own governance, their ability to develop and enforce rules, the instruments available to improve governance practices, institutional investors, and the incentives and disincentives to better governance.

The responses to the survey served as the basis for much of this background paper. While not all of the institutions that were contacted responded, responses were received from enough countries (10) to develop a reasonably accurate picture of the issues facing both regulators and exchanges. Responses were received from regulators in Armenia, Azerbaijan, Belarus, Kyrgyz Republic, Moldova, Tajikistan, Ukraine and Uzbekistan. The stock exchanges that responded were from: Armenia, Azerbaijan, Kazakhstan, Georgia, Moldova and three Ukrainian exchanges. Responses had not been received from Mongolia or Turkmenistan as of 8 June, 2012.

The survey was then supplemented with publicly available research. Stock exchange and regulatory authorities are encouraged to update the text and comparative tables in this paper, and to provide questionnaire responses if they have not yet done so, before a final revised document is tabled for the November 2012 meeting of the Group.

The paper is organised as follows: Section 1 addresses the links between corporate governance and capital markets, and the role of capital markets in economic growth. Section 2 provides an updated overview of the macroeconomic situation of the region over a twenty-year perspective as well as a brief overview of the business environment. Section 3 presents the size of capital markets and the capital market regulatory and stock exchange environment. It also reviews the privatisation implementation of Eurasian countries with a link to capital markets. This section has been supplemented with data from the 2012 OECD survey. Section 4 begins to examine what steps might be needed to achieve the goal of better and stronger capital markets and proposes a number of issues for further discussion.
1. Corporate Governance, Capital Markets and Economic Growth

8. The underlying premise behind the drive for better corporate governance across developing and developed economies alike is the view backed by a range of empirical studies and experience – that good corporate governance underpins stable and effective capital market growth, which in turn is an important factor in support of economic growth. The quality of corporate governance impacts on the whole investment process, influencing an economy’s ability to mobilise capital as well as the effectiveness with which this capital is allocated and its use is monitored.

9. A key reference in this respect is the OECD’s review of the first four years of experience from its Regional Corporate Governance Roundtables held in Asia, Eurasia, Southeast Europe, Russia, and Latin America. The report (OECD 2003) concluded, “In emerging market economies, the experiences of economic transition and all too frequent financial crises have confirmed that a weak institutional framework for corporate governance is incompatible with sustainable financial market development. Good corporate governance helps to bridge the gap between the interest of those that run a company and the shareholders that own it, increasing investor confidence and making it easier for companies to raise equity capital and finance investment in the process. Good corporate governance also helps ensure that a company honours its legal commitments, and forms value-creating relations with stakeholders including employees and creditors.”

10. Two additional references are the Eurasia Corporate Governance Roundtable’s Corporate Governance in Eurasia: a Comparative Overview (OECD 2004) which pointed to several elements of corporate governance that are important to improve company performance, attract investment and spur economic growth in the region, and Securities Markets in Eurasia (OECD 2005) which contains an overview of securities markets in the region and selected country reports. It provides comprehensive data and analyses of securities markets in the region updated to April 2005. It addresses measures to develop securities markets and infrastructure, the role of institutional investors, clearing and settlement systems, building investor confidence, and the regulation and supervision of securities markets.

11. An important contextual consideration is that corporate governance models for the Eurasian region should be tailored to the specific characteristics of Eurasian markets. As noted later in this report, Eurasia’s capital markets were largely introduced two decades ago through mass privatisation programmes. These new markets were encumbered both by the absence of an equity culture and the absence of market incentives. Ultimately what resulted were markets with low liquidity and little trading volume, and companies with problematic governance structures that had some of the negative characteristics of both concentrated and dispersed ownership.

12. Both concentrated and dispersed ownership can work well depending upon the context. Dispersed share ownership is prevalent in the US, UK and Australia, while more concentrated share ownership is more common in continental Europe and Asia. However, in Eurasia strong controlling shareholders and newly emerging regulatory institutions were associated with an increased risk of asset stripping, abusive related party transactions, self-dealing, tunnelling and other forms of minority shareholder

4 http://books.google.es/books?id=E5pWwn9bYgC&printsec=frontcover#v=onepage&q&f=false
abuse. At the same time, markets for control and the consolidation ownership were thwarted by illiquid markets and the large numbers of small shareholders that resulted from mass privatization.

13. To counter these risks and to establish arrangements that can contribute to high company performance and more vibrant capital markets, a number of corporate governance priorities tend to be emphasised, including the need for:

- **Improved transparency and disclosure.** This refers not only to reporting based on international standards and practices for accounting, audit and non-financial disclosure, but also disclosure of ownership structures of companies and shareholders, including both controlling shareholders and institutional investors, in order to be able to understand conflicts of interest and to manage them in such a way as to minimize the risk of abuse.\(^5\)

- **Effective exercise of shareholder rights and responsibilities.** The Eurasia *Comparative Overview* found that both minority and majority shareholders have suffered from the low liquidity within the markets, as in many cases it has not been feasible for Eurasian small shareholders to sell their shares to owners who can more effectively exercise their rights as shareholders. Conversely, large and controlling shareholders have encountered obstacles to the consolidation of their stakes and generally to their participation in the corporate governance process of the companies they own. Weak shareholder rights have been among the impediments to the development of the market for corporate control in the region, which undermines the incentives for company management to restructure, improve operations and look for profitable opportunities to take the company forward and attract investors.

- **Boards of Directors capable of objective, independent judgement.** The *Comparative Overview* suggested a particular need for boards to improve their role in strategic planning, monitoring of internal control systems, and independent review of transactions involving managers, controlling shareholders and other insiders. It found that problems related to boards’ independence, diligence and sometimes unclear role vis a vis management have led to persistent problems of abuse of minority shareholders within the region.

- **Credible enforcement capacities for corporate governance-related requirements.** Experience in developing and emerging economies has shown that regulators are the main line of defence for shareholders. It is essential for such regulators to have the resources, independence and integrity to play an effective role in ensuring that regulatory requirements related to disclosure, shareholder rights and other corporate governance arrangements are respected. These regulators can also play an important role in ensuring that stock exchanges and other self-regulatory bodies observe high ethical and professional standards. Effective regulatory enforcement also requires the backing of an independent, knowledgeable and predictable judiciary.

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14. The *Comparative Overview* concluded that Eurasian markets were still strongly reliant on bank lending and that the capital markets were not yet able to provide efficient debt and equity financing or offer a secondary market in ownership. The Roundtable in its second phase (2006-2008) therefore concentrated specifically on a joint initiative with the European Bank for Reconstruction and Development to promote better corporate governance of banks as one of the leading sources of corporate finance in the region.

15. In addition, private equity, venture capital and other funding vehicles have also played a role in financing corporate development in recent years. Corporate governance remains relevant in such cases, but adjustments are necessary to fit the particular context of a more restricted set of owners and the corporate governance measures that they may seek as a condition for their investments.

16. Finally, a number of emerging markets in other parts of the world have experienced rapid capital market growth during the past decade at the same time as they have undertaken significant corporate governance improvements, such as in Brazil and a number of Asian economies, while Eurasia’s capital markets remain at a less developed stage. With economic growth projected to slow during the next five years (see next two figures for details), it is both important and timely to try to understand more clearly what the main obstacles to capital market development have been, how better corporate governance may help to address them, and to reconsider the potential role for capital markets to more strongly support economic growth in the region in the future.

2. Macroeconomic Overview of the Region

17. The dissolution of the Soviet Union was followed by a deep recession in the first half of the 1990s. Although all countries in the region showed better performances in the second half of the decade, the average annual growth rates were still negative except in Mongolia which experienced mild marginal growth. On the other hand, in the first decade of this century, Eurasian countries have achieved high annual growth rates, which have exceeded both the world and advanced economies’ averages. Along with their considerable reforms in transition to a market economy, oil and natural gas resources helped Azerbaijan, Turkmenistan and Kazakhstan to occupy the first three places. Beyond these three countries, most other economies in the region have also had high average growth rates compared to other emerging and developing economies.

18. In addition, considering the strong relationship between national savings and economic growth, the high national saving ratios may have helped Eurasian economies to sustain high growth rates during the last decade. The gross national savings have been gradually increasing after 2000 and reached relatively high levels in Azerbaijan, Mongolia and Kazakhstan in 2010 (46%, 37% and 35% respectively). In principle, high savings rates are conducive to the growth of capital markets by generating demand for long-term savings instruments.

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6 See World Bank (2011)
19. In the near-term the growth outlook for the region is expected to remain broadly positive. Growth was helped as oil and gas exports continued to expand during the second half of 2011. The region benefited from strong oil and commodity prices, strong domestic demand, and increased agricultural output in Armenia, Belarus, and Kazakhstan.7

20. Growth is expected to slow in 2012 even if oil prices remain high. The region has been affected by spill overs from the euro area. Russian demand has weakened and it is feared that the Euro crisis could lead to a global downturn which would, in turn, affect commodity prices. Despite weaker external conditions, growth will be supported by strong terms of trade, as well as investment in oil and mining (Kazakhstan) and infrastructure (Kazakhstan and Uzbekistan). Azerbaijan’s hydrocarbon output is expected to remain stable, and growth in the non-hydrocarbon sector is expected to help the economy expand by 3 per cent in 2012.

21. In the energy-importing economies, external and domestic factors are contributing to the slowdown. Both reduced export demand and tighter monetary and financial conditions are contributing factors. Growth is expected to slow to 3 per cent from 5¼ per cent last year in both Belarus and Ukraine.8

22. Historically, Eurasian countries have faced elevated inflation, especially in the first five years of their independence. Inflation has been reduced across the region, with median inflation in 2011 of 8.4%.9 Still, some countries Tajikistan (14% in 2011), Turkmenistan (15% in 2011), and Uzbekistan (16% in 2011) have high consumer price inflation compared to the world (2.5%) and developing economies (5.6 %). Belarus has been suffering significant inflationary pressure, moving from 7.7% in 2010, to 52% in 2011.10 Controlling inflation is important for the development of capital markets

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7 IMF (2012), World Economic Outlook, Growth Resuming, Dangers Remaining, April 2012.
8 IMF (2012), World Economic Outlook, Growth Resuming, Dangers Remaining, April 2012.
9 OECD based upon World Bank Development Indicators.
10 World Bank Development Indicators supplemented by the CIA World Factbook.
because excessive inflation contributes to capital flight to foreign jurisdictions at the cost of investment into local alternatives.

**Figure 2: Historical and Projected Average Annual Real GDP Growth Rates (%)**

Source: OECD calculations based on data from IMF and EBRD.

*Based on IMF’s World Economic Outlook April 2011 estimations.

23. The overall environment for conducting business has improved in the region over the past half decade. According to the World Bank’s *Doing Business* report, the business environment has improved greatly in Azerbaijan, Georgia, Kazakhstan and the Kyrgyz Republic. Each country significantly raised its ranking between 2006 and 2011. Most noteworthy is Georgia which rose to occupy 12th position globally in 2011. This made Georgia the highest ranked country in the region and placed it on par with many developed countries. Significant improvements were also visible in Kazakhstan. Still, most countries in the region score poorly on some World Bank indicators. While many countries have an overall rank that is similar to or higher than low-income countries, the *Global Competitiveness Indicator* of the World Economic Forum confirms that scores are below average for emerging market economies.

24. It is worth remembering that an additional and important factor that defines the business environment is the quality of public sector governance. Public sector governance appears to be improving in most of the countries in the region. However, the World Bank’s *World Governance Indicators* indicate that, with the exception of Georgia, the rule of law and control of corruption remain relatively weak and could pose an impediment to the conduct of business. Seven of 10

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11 IMF (2011), World Economic and Financial Surveys, Regional Economic Outlook, Middle East and Central Asia, pp. 73-75.
countries for which data was available in the World Economic Forum’s *Global Competitiveness Report* cite corruption as one of the top three most problematic factors for doing business.\textsuperscript{12}

3. Capital Markets Landscape in Eurasia

25. The capital markets in Eurasia only have a two-decade history. However, over the last decade the strong performance of these economies has engendered interest both from national and international players in these markets. Yet, despite what has been achieved in the past twenty years, regional capital markets are still at an early stage of development. With respect to FTSE and S&P indices, none of the Eurasian markets is classified as an emerging or frontier market, with only Kazakhstan on the watch list to become a frontier market of the FTSE\textsuperscript{13}. Another index company, MCSI, has classified Kazakhstan and Ukraine as frontier markets.

26. The World Economic Forum’s *Global Competitiveness Report* assigns scores to countries on the basis of 12 pillars, including financial market development. Azerbaijan is the Eurasian country with the best rank among 142 countries. More important, with the exception of Kyrgyz Republic, all Eurasian countries’ financial market development rankings are lower than their own overall competitiveness ranking indicating that financial markets are an area of concern. In particular, their performance on the sub-pillars *financing through local equity market* and *regulation of securities exchange* appears to have a negative effect on the countries’ overall competitiveness.

| Table 1. Ranking of Financial Market Development in Eurasia (lower numbers are better) |
|-------------------------------------------|-------------------------------------------|-------------------------------------------|-------------------------------------------|-------------------------------------------|-------------------------------------------|
|                           |                            | Availability of financial services | Ease of access to loans | Financing through local equity market | Venture capital availability | Regulation of securities exchanges |
| Azerbaijan                | 94                          | 98                           | 69                         | 77                         | 54                         | 88                         |
| Armenia                   | 95                          | 102                          | 85                         | 120                        | 109                        | 110                        |
| Georgia                   | 99                          | 107                          | 79                         | 122                        | 97                         | 122                        |
| Moldova                   | 105                         | 122                          | 109                        | 128                        | 126                        | 120                        |
| Kyrgyz Republic           | 113                         | 133                          | 131                        | 131                        | 136                        | 134                        |
| Ukraine                   | 116                         | 115                          | 128                        | 123                        | 114                        | 127                        |
| Tajikistan                | 119                         | 118                          | 64                         | 100                        | 57                         | 125                        |
| Kazakhstan                | 121                         | 91                           | 120                        | 107                        | 92                         | 112                        |
| Mongolia                  | 129                         | 124                          | 136                        | 97                         | 137                        | 131                        |


\textsuperscript{12} OECD based upon information found in the World Economic Forum’s Global Competitiveness Report 2011-2012.

\textsuperscript{13} FTSE categorises markets as Developed, Emerging, Secondary Emerging and Frontier, with the Frontier Index, currently covering 25 countries, established to signal the first step to being covered by an index. FTSE note on Kazakhstan: “FTSE placed Kazakhstan on the Watch List for admission to Frontier status in September 2008. FTSE continues constructive engagement with officials at the Kazakhstan Stock Exchange. One of the key outstanding issues requires reform of the T+0 settlement cycle to international standards.” (FTSE, 2011).
27. The *Global Competitiveness Report* also tracks what companies consider the most problematic factors for doing business. An analysis of the World Economic Forum data by the OECD indicates that businesses in six of 10 countries cite access to finance as one of the most problematic factors for doing business. Access to finance covers the full spectrum of financial markets ranging from bank lending, to equity markets to venture capital. The various sources of finance seem to be correlated; a weakness in one tends to be reflected as a weakness in the others.

28. In a similar study, the OECD’s *Policies for Competitiveness Assessment Framework* reviews human capital development, investment promotion and access to finance as the three main dimensions of the assessment. According to the preliminary results of the assessment, under the access to finance dimension, the largest gap between the best practice level and the current situation in Central Asian countries (excluding Turkmenistan and Uzbekistan) is on the access to capital market criteria (OECD, 2011). Therefore, capital markets in the region do not yet appear to have been an important factor in the region but with improvements in their functioning retain the potential to positively influence economic growth and competitiveness in the future.

**Figure 3. Financial Depth in Eurasian Economies**

Source: Based on data from World Bank and EBRD

29. Financial market depth is mostly defined as the size of the financial system to the GDP, while financial breadth provides the relative importance of banks to capital markets and diversification of the financial system. Private credit and stock market capitalisation as per cent of GDP are the most widely used measures used as a basis for these two indicators (ADB, 2010). As seen in Figure 3, at the beginning of the new century, both financial depth and breadth indicate a similar level of development for regional economies. During the last decade, Eurasian stock markets showed low performance relative to the banking sector. In Ukraine, before the financial turbulence in 2008, equity markets reached a high of 78.3% of GDP. Equity markets subsequently plummeted though bank lending actually grew from 61.1% in 2007 to a high of 88.6% in 2009 before levelling off in 2010.
Table 2. Domestic Credit Provided by Banking Sector as % of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>17</td>
<td>20</td>
<td>25.8</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>16.2</td>
<td>22.5</td>
<td>23.5</td>
</tr>
<tr>
<td>Georgia</td>
<td>32.9</td>
<td>33.1</td>
<td>33.8</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>54.2</td>
<td>54.6</td>
<td>45.4</td>
</tr>
<tr>
<td>Moldova</td>
<td>39.8</td>
<td>41.4</td>
<td>37.2</td>
</tr>
<tr>
<td>Mongolia</td>
<td>31.6</td>
<td>29.6</td>
<td>29.9</td>
</tr>
<tr>
<td>Ukraine</td>
<td>82.1</td>
<td>88.6</td>
<td>78.6</td>
</tr>
<tr>
<td>OECD Members</td>
<td></td>
<td></td>
<td>202.2</td>
</tr>
<tr>
<td>World</td>
<td></td>
<td></td>
<td>167.6</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td></td>
<td></td>
<td>50.8</td>
</tr>
</tbody>
</table>

Source: World Bank Indicators. No information available on: Kyrgyz Republic, Tajikistan, Turkmenistan, or Uzbekistan.

Table 3. Market Capitalization of Listed Companies % of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>1.5</td>
<td>1.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Georgia</td>
<td>2.6</td>
<td>6.8</td>
<td>9.1</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>23.3</td>
<td>50</td>
<td>40.8</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>1.8</td>
<td>1.5</td>
<td>1.7</td>
</tr>
<tr>
<td>Mongolia</td>
<td>7.2</td>
<td>9.4</td>
<td>17.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>13.5</td>
<td>14.3</td>
<td>28.6</td>
</tr>
<tr>
<td>OECD Members</td>
<td></td>
<td></td>
<td>91.4</td>
</tr>
<tr>
<td>World</td>
<td></td>
<td></td>
<td>88.7</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td></td>
<td></td>
<td>51.8</td>
</tr>
</tbody>
</table>

Source: World Bank Indicators. No information available on: Azerbaijan, Moldova, Tajikistan, Turkmenistan, or Uzbekistan.

30. Compared to OECD Member countries, World Markets, and Europe and Central Asia, the depth of financial markets is still low, thus echoing the findings in the Global Competitiveness Report that access to finance is one of the greatest barriers to doing business in the region.

a. Equity and Bond Markets

31. Market capitalisation of listed companies, especially as a percentage of GDP, is the most commonly used indicator to compare stock market development among national economies. Kazakhstan has the largest equity market in the region, both as percentage of GDP (40.8 %) and total market capitalization (USD 43.3 billion in 2011 down from USD 60.7 billion in 2010),\(^{14}\) Ukraine (28.6%) and Mongolia (17.6 %) also have relatively more developed stock markets.

32. Nevertheless, comparisons based solely upon market capitalization may be misleading due to the fact that stock market capitalisation by definition covers not only the free floating part of listed companies’ shares but also the value of all outstanding shares. Levels of free float in Eurasian countries can be quite low, as is evident from Annex 1 showing liquidity levels in each Eurasian market.

33. The low level of liquidity in Eurasian stock markets is also related to the methods that have been adopted for mass privatisation transactions in the 90s. In Mongolia, the government provided vouchers to each citizen with a right to purchase state shares in SOEs. The reorganisation and listing of 475 SOEs was the first step for capital market development. In practice privatisation did not have the

\(^{14}\) The largest stock market in the region, Kazakhstan was the 47th largest market capitalisation as percent of GDP out of 97 economies in the world at the end of 2010 (World Bank Development Indicators). http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS
intended effect of creating vibrant equity markets. In some cases, newly privatised companies were either not viable or were stripped of their valuable assets. In other cases, new shareholders, unfamiliar with share ownership, sold their shares to cover their daily financial needs. Eventually, government decided to sell its remaining shares through auctions, which resulted in a sharp decrease in market liquidity (Tsolmon, 2008).

34. As Annex 1 shows, the number of local listed companies has shrunk across the region over the past decade, especially after the 2008 global financial crisis. In some cases the decline was dramatic; for example, in Armenia the number of companies declined from 198 in 2005 to just two companies by the end of 2010, and in Ukraine from 276 in 2007 to 183 by the end of 2010. Mass privatisation transactions through stock exchanges initially helped countries to reach a high number of listed companies. However, there has been a downward trend due to delisting of many of these companies and lack of new listings.

35. The size of corporate bond markets in Eurasian countries is even smaller than the stock markets. There are active bond markets in Azerbaijan, Belarus, Kazakhstan, Mongolia and Ukraine but most concentrate on government bonds rather than serving as a source for private sector financing. For example, in Kazakhstan, government bonds accounted for nearly 84% of total trade volume in the bond market in 2010. Similarly, in Azerbaijan, the corporate bond market covers only 11.9% of total trade volume.

36. Institutional investors do not play a major role in the domestic capital markets of most Eurasian countries, with the possible exception of Kazakhstan and Ukraine. Pension funds and life insurance companies, both domestic and foreign, have the potential to play a stronger role as they do in some other emerging markets. However, due to their conservative nature, foreign pension funds will unlikely invest in regional financial markets, and more time is required for people to understand and participate in life insurance systems in the region (Kitamura, 2005). So far, only in Kazakhstan and Ukraine, institutional investors, mostly local domestic pension funds, have been active in the financial markets. In Ukraine, 108 non-state pension funds were registered in 2009, with about a half million participants. Their assets mostly consisted of bank deposits and cash (42.8%) together with government and corporate bonds (36.2%), but they also have some investments in Ukrainian stocks (8.8%) (OECD, 2009).

b. Capital Market Regulatory Framework

37. The introduction of securities regulations and the establishment of capital market authorities started in the mid-1990s, as part of Eurasian countries’ transition to a market economy. In some countries, securities regulators have been structured as independent state bodies (Azerbaijan, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Ukraine and Uzbekistan), while in others their functions are consolidated under Central Banks (Armenia, Georgia and Kazakhstan) or relevant Ministries (Belarus, Turkmenistan).

38. Similar to the stock exchange industry, there have been recent significant developments in the capital market regulatory environment. For instance, the liquidation of the Armenian Securities Commission and transfer of its regulatory functions to the Central Bank in 2006 was followed by the demutualisation of the Armenian Stock Exchange. Georgia has also unified capital market authority
with the insurance regulator under the Central Bank. On the other hand, in Kazakhstan, the seven-year old Financial Supervision Agency and the four-year old Agency of Regional Financial Centre of Almaty were consolidated under the National Bank in 2011. In Ukraine, the regulatory framework regarding the Securities and Stock Market National Commission’s status, composition and appointment of the commissioner was amended in 2011.

c. Regulatory independence

39. As one of the twelve key standards designated by the Financial Stability Board for sound financial systems, the IOSCO Objectives and Principles of Securities Regulation state that capital market regulators should be operationally independent and accountable in the exercise of their functions and powers. Moreover, the OECD Principles recommend that regulators should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. However, the IOSCO Objectives and the OECD Principles do not specify whether regulatory authorities need to be independent state bodies. Rather, more important than the particular form is whether these institutions have operational independence, and whether decision making is independent and taken in the public interest.

40. The EBRD conducted a securities markets legislative assessment project in 2007 for all regional countries, including assessments of the independence of regulators. According to this assessment, regulatory authorities from all three types of organisational models have been assessed to review how the law seeks to ensure their operational independence when exercising their respective functions and powers. Only three countries’ authorities, Belarus, Tajikistan and Uzbekistan, do not have such a requirement in law. The Belarus Securities Department under the Ministry of Finance is commented to be significantly influenced by the Ministry and other influential state authorities. Tajik and Uzbek legislation do not explicitly require the independence of regulatory authorities.

41. The independence of the heads of regulatory agencies and commissioners is equally a concern. In the 2012 OECD survey most heads of regulators were appointed by presidential decree (Azerbaijan, Belarus, and Ukraine) or a prime minister (Kyrgyzstan) sometimes with the approval of parliament. This seems to correspond to practice in developed countries. While the appointment itself is clearly at the prerogative of elected officials, developed countries often seek to augment the independence of commissioners by prohibiting their dismissal by the appointer.

42. Such a safeguard is not visible in Eurasia where dismissal of an agency heads and commissioners is possible at the discretion of the appointer in all countries that responded to the survey. On the other hand, both Belarus and Ukraine specify that such dismissal is not possible for reasons related to policy. Other factors that are supposed to encourage independence are restrictions on the ability of the agency head or commissioners to hold other offices in government, restrictions on the ability of the agency head or commissioners to accept jobs in the capital markets after the completion of their terms, and the protection of the regulator from wanton overturning of its decisions. In seven out of eight regulatory bodies, agency heads or commissioners are not allowed to hold other offices in government. In Azerbaijan there are no specific provisions. Only Ukraine restricts the agency head/commissioners from accepting work in the capital markets after their term expires (for a period of one year). As far as decision-making is concerned, none of the surveyed countries permit the overturning of decisions made by the regulatory authority in areas where the regulator has exclusive competency.
43. Regulators in the region were also surveyed regarding their financial and operational independence. In most countries the government is the source of the regulator’s funding, with two regulators being funded by levies on regulated firms (Armenia and Moldova). In only one case (Armenia) was the regulator able to exercise exclusive control over its own budget once it had been appropriated. In most countries (Belarus, Kyrgyzstan, Tajikistan and Ukraine) control over the regulator’s budget was shared between the regulatory authority and government. In only one case (Azerbaijan) did the government maintain full control.

44. With respect to the regulator’s internal organisation, such issues are decided by the regulator in four out of seven cases (Armenia, Kyrgyzstan, Moldova, and Ukraine). In three out of seven cases (Azerbaijan, Belarus and Tajikistan) issues of internal organisation are decided by the regulator in cooperation with the government. In no case is it determined exclusively by government. Personnel policies seem to be an area where government does get involved. In only two of seven respondents (Armenia, Moldova) were personnel decisions taken exclusively by the regulator. In the remaining cases such decisions were taken cooperatively.

45. Taken together, these indicators suggest that at least some rules are in place and that regulators enjoy some level of independence with respect to policy, financial and operational decisions. However, feedback from the EBRD’s 2007 assessment project also suggests that the picture is more nuanced and that in some countries the state involves itself fairly actively in the work of the regulator. Thus, the findings of the OECD survey need to be supplemented by further discussions to ascertain the degree to which regulators do enjoy needed independence and the extent to which the intent of law is reflected in practice.

d. Institutions that Promote Better Corporate Governance Practices

46. Regulators, principally securities exchange commissions, are the main institutions that promote better corporate governance practices in the region. But there also others including central banks and ministries. In Uzbekistan local business schools were cited as important promoters of better practice. In a few countries, NGOs have been active in trying to promote better corporate governance such as, for example, the Corporate Governance Development Centre in Mongolia, the Ukraine Corporate Governance Association and the Financial Institutions Association of Kazakhstan. Institutes of directors are clearly rare. The International Finance Corporation of the World Bank was also recognised as an important outside force for promoting good governance throughout the region. With respect to legal institutions, most respondents have no special courts to adjudicate corporate governance issues. Usually high courts dedicated to adjudicating economic issues or issues related to company law.

47. While there may be a number of stakeholders actively promoting the governance agenda, the survey also showed that it is uncommon for government and other bodies to address corporate governance issues in a co-ordinated fashion. Where co-ordinating bodies do occur (Kyrgyz Republic and Ukraine) they reside within the securities exchange regulatory body. The question arises with respect to the extent to which governance reform efforts might not be facilitated by a more co-ordinated approach or, at a minimum, with more formal information sharing meetings and a more inclusive policy dialogue.
48. International and regional organisations are also important promoters of good governance and are valuable sources of information and practice (e.g. OECD, IFC, EBRD, ADB, FEAS, etc.). In addition, a number of Eurasian regulators are regular members of IOSCO\textsuperscript{15}, although none of them have signed IOSCO’s \textit{Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information} (MMoU). This MMoU establishes international standards for co-operation and information exchange for enforcement purposes amongst its signatory securities regulators. The lack of Eurasian signatories to this international agreement may be seen as a weakness of the regional authorities’ international co-operation and enforcement capacity. On the other hand, Armenia, Kazakhstan and Mongolia’s commitments to seek “the legal authority necessary to enable them to become full signatories” show the rising interest in international co-operation.

e. Information Disclosure

49. One of the fundamental underpinnings of good corporate governance is transparency and disclosure. Investors may accept a company’s governance choices even when they do not correspond to the investor’s view of best practice. However, investors will uniformly insist upon transparency with respect to the company’s policies and choices in order to inform their investment decision. Only good information allows them to assess the potential risks. The simple absence of information generates information risk. This risk is inevitably factored into any pricing decision.

50. Disclosure practices have improved significantly in Eurasia. Among the respondents to the OECD survey, all countries require listed companies to publish audited annual reports. Six out of seven countries also require the immediate reporting of price-sensitive information, a requirement that is typically associated with the most developed financial markets. Furthermore, six out of eight require the disclosure of quarterly financial statements (the two that do not are Moldova and Tajikistan). No country has legal requirements for semi-annual reports though some stock exchanges appear to do so in addition to law.

51. According to the OECD survey, the information that is required in annual reports generally compares well with world-class disclosure requirements. The great preponderance of countries require the essential components of a good annual report.

52. The areas where there are clear weaknesses are the disclosure of Management’s Discussion and Analysis, which is mandatory only in Armenia and Uzbekistan. In addition, a report by the board on past and future operations was required in only half the cases (Azerbaijan, Belarus, Tajikistan and Uzbekistan). It is no coincidence that both of these items are important items of non-financial disclosure.

\textsuperscript{15} Armenia, Kazakhstan, Kyrgyz Republic, Mongolia, Ukraine and Uzbekistan securities regulators are the regular members of the IOSCO. According to the IOSCO website list, the Kazakhstan Financial Supervision Agency which was consolidated under National Bank by a Presidential Decree dated April 2011 is the member authority from Kazakhstan.
Table 4. Information Required in a Listed Company Annual Report

<table>
<thead>
<tr>
<th>Information required</th>
<th>Frequency</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) General information on the company</td>
<td>6 of 8 require</td>
<td>Armenia, Tajikistan</td>
</tr>
<tr>
<td>(b) Audited annual financial statements</td>
<td>All require</td>
<td></td>
</tr>
<tr>
<td>(c) Financial status of the company</td>
<td>6 of 8 require</td>
<td>Armenia, Tajikistan</td>
</tr>
<tr>
<td>(d) Directors’ report on past and future operations</td>
<td>4 of 8 require</td>
<td>Armenia, Kyrgyzstan, Moldova, Ukraine</td>
</tr>
<tr>
<td>(e) Consolidated financial reports</td>
<td>5 of 8 require</td>
<td>Azerbaijan, Belarus, Tajikistan</td>
</tr>
<tr>
<td>(f) Information on corporate governance</td>
<td>6 of 8 require</td>
<td>Moldova, Tajikistan</td>
</tr>
<tr>
<td>(g) Management Discussion &amp; Analysis</td>
<td>2 of 8 require</td>
<td>Azerbaijan, Belarus, Kyrgyzstan, Moldova, Tajikistan, Ukraine</td>
</tr>
<tr>
<td>(h) Shares held by the controlling shareholder (including indirect shares)</td>
<td>6 of 8</td>
<td>Ukraine, Tajikistan</td>
</tr>
<tr>
<td>(i) Share ownership (as of the closing date)</td>
<td>5 of 8</td>
<td>Azerbaijan, Belarus, Tajikistan</td>
</tr>
<tr>
<td>(h) Significant related party transaction(s)</td>
<td>6 of 8</td>
<td>Belarus, Tajikistan¹⁶</td>
</tr>
</tbody>
</table>


53. While financial reporting practices seem to have improved, non-financial disclosure appears to have lagged. Corporate governance disclosure is required in five of eight countries (Azerbaijan, Moldova and Tajikistan do not require such disclosure). However, key elements of non-financial disclosure are missing. Only two countries (Kyrgyzstan and Ukraine) require disclosure of the education and professional experience of board members and key executives. Likewise, the disclosure of executive remuneration either individually or in the aggregate is comparatively rare occurring only in Kyrgyzstan and Ukraine. A more in-depth review of non-financial reporting requirements in Eurasian countries may be in order, in particular, as compared to the OECD Principles of Corporate Governance disclosure recommendations and the more detailed UNCTAD Guidance on Good Practices in Corporate Governance Disclosure (see footnote 5 above).

Table 5. Non-financial Disclosure Requirements

<table>
<thead>
<tr>
<th>Non-financial disclosure</th>
<th>Frequency</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Corporate governance structures and practices</td>
<td>5 of 8 require</td>
<td>Azerbaijan, Moldova, Uzbekistan</td>
</tr>
<tr>
<td>(b) Education and professional experience of directors and key executives</td>
<td>2 of 8 require</td>
<td>Only Kyrgyzstan and Ukraine require</td>
</tr>
<tr>
<td>(c) Total remuneration of directors and key executives</td>
<td>1 of 8 requires</td>
<td>Only Kyrgyzstan requires</td>
</tr>
<tr>
<td>(d) Individual remuneration of directors and key executives</td>
<td>2 of 8 require</td>
<td>Only Kyrgyzstan and Ukraine require</td>
</tr>
<tr>
<td>(e) Deviations from corporate governance codes</td>
<td>4 of 8 require</td>
<td>Only Armenia, Kyrgyzstan, Tajikistan and Ukraine require</td>
</tr>
</tbody>
</table>


¹⁶ Tajikistan reports full compliance with IFRS but does not report requiring related party transaction disclosure in annual reports. This presents an inconsistency. Disclosure of related party transactions are required under IFRS (IAS 24) raising questions regarding the degree of IFRS compliance.
54. Finally, disclosure of compliance with codes of corporate governance appears weak. While six of eight countries have corporate governance codes that have been endorsed by a stock exchange, (Kyrgyzstan and Uzbekistan do not) only four countries require disclosure of compliance with their code. The relative scarcity of disclosure requirements for code compliance may emanate from the fact that some Eurasian countries consider their codes to be mandatory. The implication is that if they are mandatory then codes do not rely upon disclosure to the markets for enforcement. Rather, enforcement is done directly by the regulator.17

55. Some countries may have relied on corporate governance codes as a quick way of raising corporate governance standards without having to undergo a fundamental and time consuming overhaul of company law. As such, many requirements that should be included in basic regulation may, in some cases, be found in voluntary codes. Overall, there may be cause for concern regarding the role of codes versus the role of law and how both law and codes are being enforced.

56. Most Eurasian countries impose penalties for non-compliance with disclosure requirements that range from warnings and fines to a suspension of trading and eventually delisting (Armenia, Moldova and Ukraine's PFTS cannot). Fines can be as little as USD 20 for individual offenders in Kyrgyzstan to approximately USD 2,000 in Ukraine and a maximum of USD 10,000 for repeat offenses. It is worth considering whether the level of fines has any dissuasive effect, particularly for large listed companies. Four out of eight exchanges have delisted companies for non-compliance with rules. Whether delistings are really sanctions on operating companies for non-compliance or whether they are more of an administrative delisting of non-operational companies remains to be ascertained.

57. Adopting the key standards designated by the Financial Stability Board (FSB) as necessary for the proper functioning of capital markets (IFRS, ISAs, IOSCO principles, the IOSCO MMoU and the OECD Principles among others) would support compliance of the national securities market frameworks with international standards, help develop Eurasian capital markets and increase their credibility among international investors.18

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17 In those countries where the first best practice corporate governance codes originated there was a tradition of enforcement using what is referred to as “comply or explain”, which means that while compliance with the code is voluntary, non-compliance is to be accompanied by an explanation. Such comply or explain enforcement was adopted in some transition countries despite the fact that many had limited experience with disclosure-based regulation and more merit-based civil law traditions.

18 FSB Key Standards for Sound Financial Systems can be found at the following web site: http://www.financialstabilityboard.org/cos/key_standards.htm
58. With respect to financial reporting standards, four of six responding countries report full compliance with IFRS. According to the 2012 OECD survey, Belarus does not comply and Moldova reports that it is in transition. In spite of this generally positive assessment, full compliance is only visible in the largest and most advanced listed companies, often those with dual listings, and is not generalizable to others, according to a 2011 study by Price Waterhouse Coopers.

59. In some countries out-dated translations and/or incomplete versions of IFRS are accepted (PWC, 2011). While the broad adoption of IFRS is an important indicator of the quality of financial reporting, the way in which these standards are implemented in practice is the critical factor. The quality of financial reporting will ultimately depend upon capital market authorities’ commitment and enforcement capacities.

60. In terms of the assurance services provided for financial reporting, all countries responding to the OECD survey require an external audit of listed company financial statements. All countries require certification or training of auditors and six of seven have ethics codes for the profession. Only Ukraine reported that the ethics code is that of the International Ethics Standards Board for Accountants (IESBA), which is recognized as the global standard of best practice. There is, however, little data to describe the capacities of external auditors or if external audit is conducted in compliance with ISA, which is the global standard for audit and one of the key standards identified by the FSB.

61. In most cases, requirements for the appointment of the external auditor appears to adhere to best practice in that it is approved by shareholder vote at the AGM. Certainly, the official reporting relationship to the board and accountability to the AGM are visible in law. However, there is insufficient information to substantiate the notion that boards or the AGM are attentive to questions of the quality of the external audit and, in particular, the independence of the external auditor.

62. In five out of the seven responding countries a ministry of finance exercises oversight over the accounting profession, and accounting and audit standards. Ministries of finance have traditionally exercised this role since all accounting was tax accounting before the transition. Tax accounting is of overriding importance because it serves as the tool with which the state calculates taxes and collects revenues. With the introduction of financial reporting for markets, ministries of finance have continued their traditional standard-setting and oversight role albeit with greater input from the accounting and audit profession. Local chambers of auditors have not generally been able to step into the self-regulatory role that they have in more developed markets.

63. Accounting and audit reform is a challenging and complex process. Engagement has occurred at the country level with many countries reporting significant advances in the statutory framework, accounting and audit standards, and professional practices. However, in practice, the production of a fully IFRS compliant statement audited in full compliance with ISA still represents a major challenge. Detailed analyses of the accounting and audit framework, as well as practices have been done in the context of the World Bank’s ROSC programme (Reports on the Observance of Standards and

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19 IFRS is required in Armenia, Azerbaijan, Kazakhstan, Kyrgyz Republic, and Mongolia; and permitted in Uzbekistan. Local translation is in use in Georgia and Moldova for listed companies (PWC, 2011). All listed companies, banks and insurance companies will be required to prepare their financial statements according to IFRS from the beginning of 2012.
The ROSCs also provide recommendations for reform. These should be consulted for a more in-depth discussion of reporting related issues.

f. Stock Exchanges in Eurasia

64. Apart from Tajikistan and Turkmenistan, all Eurasian countries have organised stock markets, on which mostly corporate and government bonds and derivatives are also being traded. Furthermore, in Uzbekistan, a trade platform for OTC transactions, Elsis Savdo, has been functioning since 2000.

65. Since 1993 when the first demutualisation of an exchange occurred in Sweden, there has been an on-going global trend towards demutualisation, listing on their own markets and consolidation as the main characteristics of the stock exchange industry. In addition to these structural changes, new information technologies and financial instruments have increased the competition among stock exchanges at the international level (OECD, 2009b). As of 2006, 11 of the 39 members of the World Federation of Exchanges were demutualised, and another 11 were listed (WFE, 2006).

66. In Eurasia, three main features have determined the effect of these trends on local stock exchanges: first, nearly all stock exchanges in the region were established in the mid-90s after the dissolution of the Soviet Union. Amid an international trend towards demutualisation and listing, in most Eurasian countries, stock exchanges were established as private companies. Unlike in other developing markets, there are only three state-owned stock exchanges in the region (see Table 6 below for details).

67. Moreover, exchanges which started their activities as mutual organisations have been demutualised during the 2000s. The Kyrgyz Stock Exchange was demutualised in 2000, and the Armenian Stock Exchange was demutualised in 2007 and shortly thereafter became a subsidiary of the NASDAQ OMX Group. However, member brokerage firms and banks have the majority of the shares of some exchanges categorised as privately held companies, like the Baku Stock Exchange.

68. Second, the transition and capital market development strategy of each country has had significant effects on their stock exchanges. In particular, the Ukrainian case mostly differs from other countries. Apart from Ukraine, all countries have one organised stock market, but in Ukraine, there are ten licensed stock exchanges. The largest stock exchange in terms of trade volume, PFTS, was established as an electronic trade system in 1997, and after a long period further to its application, has recently been granted exchange status. The oldest stock exchange, the Ukrainian Exchange, is a not-for-profit company. Perspectiva, the other important exchange, and Ukrainian Exchange are both privately held companies. Apart from these exchanges, remaining ones are mostly defined as “dormant” and “pocket” exchanges, which contribute to poor corporate governance and rent-seeking behaviour, and provide a place for market manipulation. Considering the need of Ukrainian markets, a consolidation of these dormant stock exchanges through voluntary mergers or repeal of licences by the capital market authority was recommended by a USAID study completed in 2006 (Smith, 2006).


21 The largest stock exchange of Russian Federation, the MICEX acquired the 50%+1 share of the PFTS in 2010. Currently
Finally, due to the low level of capital market development and the desire to maintain the national identity of stock exchanges, most Eurasian countries have opted out of the global consolidation trend. As mentioned above, demutualisation of the Armenian Stock Exchange in 2007 and the Swedish exchange operator OMX AB’s acquisition in 2008 was the first example of cross-border consolidation. One other example is Russian-owned MICEX’s acquisition of a majority stake in the Ukrainian PFTS exchange. Moreover, the strategic partnership agreement signed between the Mongolian Stock Exchange and London Stock Exchange, and the Uzbek Republican Stock Exchange’s co-operation with Korea Exchange on trading platforms are other forms of international integration of Eurasian exchanges. On the other hand, the Kyrgyz Stock Exchange’s introduction of a new trading system developed by KASE and KASE’s share acquisition in this exchange is an early example of regional co-operation.

Table 6. Stock Exchange Landscape in Eurasia

<table>
<thead>
<tr>
<th>Country</th>
<th>Stock Exchange</th>
<th>Establishment</th>
<th>Ownership Structure</th>
<th>Number of Listed Companies (End of 2010)</th>
<th>Trade Volume (Stock, million USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>Nasdaq OMX</td>
<td>2000</td>
<td>Privately-held</td>
<td>11</td>
<td>0.35</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Baku Stock Exchange</td>
<td>2000</td>
<td>Privately-held</td>
<td>2(^1)</td>
<td>551.5</td>
</tr>
<tr>
<td>Belarus</td>
<td>Belarusian Currency and Stock Exchange</td>
<td>1998</td>
<td>State-Owned Company</td>
<td>1901</td>
<td>92.9</td>
</tr>
<tr>
<td>Georgia</td>
<td>Georgian Stock Exchange</td>
<td>2000</td>
<td>Privately-held</td>
<td>138</td>
<td>2.9</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>Kazakhstan Stock Exchange</td>
<td>1993</td>
<td>Privately-held(^2)</td>
<td>118</td>
<td>1,899.6</td>
</tr>
<tr>
<td>Moldova</td>
<td>Moldovan Stock Exchange</td>
<td>1994</td>
<td>Privately-held</td>
<td>1020</td>
<td>21.7</td>
</tr>
<tr>
<td>Mongolia</td>
<td>Mongolian Stock Exchange</td>
<td>1991</td>
<td>State-Owned Company</td>
<td>336</td>
<td>48.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>PFTS Stock Exchange</td>
<td>1997</td>
<td>Privately-held</td>
<td>302</td>
<td>n.a</td>
</tr>
<tr>
<td>Ukrainian Exchange</td>
<td>2008</td>
<td>Privately-held</td>
<td></td>
<td></td>
<td>n.a</td>
</tr>
<tr>
<td>Ukrainian Stock Exchange</td>
<td>1991</td>
<td>Not-for-Profit Company</td>
<td></td>
<td>37</td>
<td>0.6</td>
</tr>
<tr>
<td>Perspectiva Stock Exchange</td>
<td>2006</td>
<td>Privately-held</td>
<td></td>
<td></td>
<td>n.a</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>Tashkent Republican Stock Exchange</td>
<td>1994</td>
<td>Public Institution(^3)</td>
<td>68</td>
<td>38.8</td>
</tr>
</tbody>
</table>

Source: National stock exchanges, FEAS

Notes:
1 In Baku Stock Exchange there are also 255 pre-listed companies, whose shares are allowed to be traded without compliance of listing requirements.
2 KASE has commercialised in 2007 and state-owned Regional Financial Centre of Almaty JSC is the largest shareholder without majority.
3 Public institutions describe non-commercialised state-owned exchange that organised as a state agency.
4 Data collected by the OECD on different occasions appears contradictory. Ukraine’s exchanges are alternatively described as privately held, not for profit and public institutions. Clarification is required.
70. In general, markets and international standard-setters have established that clearing and settlement periods for stock exchanges should be between T+1 and T+7\(^{22}\). However, as shown in Annex 2, in some Eurasian markets (Armenia, Azerbaijan, Belarus and Kazakhstan), the settlement period remains outside this range at T+0. T+0 settlement systems typically involve stock being deposited prior to a trade taking place. This can be a barrier to investment for firms that are accustomed to longer settlement cycles and is sometimes blamed for low liquidity levels. Along with market infrastructure problems, existing investment restrictions on foreign investors in some cases limit the participation of foreign institutional investors in these markets.

71. As noted above, the OECD contacted stock exchanges in all Eurasian countries in the context of the development of this report. Eight exchanges responded to requests for information. Responses were received from Armenia, Azerbaijan, Kazakhstan, Georgia, Moldova and three exchanges in the Ukraine (PFTS, Perspektiva and the Ukrainian Exchange).\(^{23}\) As noted in the table above, none of the exchanges that responded are state-owned.

72. One of the areas on which exchanges were questioned was the governance of the exchange and the degree to which exchanges are able to act independently and with operational autonomy. Only Georgia reported that its exchange had self-regulatory organisation (SRO) status. More typically, stock exchanges are regulated by a dedicated securities markets regulator or a central bank that exercises oversight over the exchange and the securities markets. In principle, the responses to the questionnaire show that states do not simultaneously exercise regulatory and operational functions. Nevertheless, other types of conflicts of interest can arise.

73. For example, in Kazakhstan listing fees are a potential source of conflict of interest when KASE exchange members are simultaneously market participants. The presence of the central bank on the KASE board of directors is aimed at keeping these conflicts in check. A similar conflict was noted in Georgia where the Bank of Georgia (not the central bank) comprises a significant part of the stock exchange turnover while at the same time having a subsidiary brokerage company that is one of the largest intermediaries on the market.

74. In all cases, responding stock exchanges employ the governance structures that are typical of joint stock companies and stock exchanges in more developed capital markets. These include a general meeting, a board, and top management (executives). Executives are appointed by boards to whom they report. In all cases, the relationship between the exchange and the securities market regulator is defined and formalised by law. In some cases the influence of the regulator is via a state representative on the board and on individual exchange committees such as is the case of KASE in Kazakhstan.

75. The role of the stock exchange in shaping the governance of listed companies varies. Without doubt the main tool at the disposal of the stock exchange is the listing requirements. Exchanges also track disclosure and compliance, and have it in their power to apply penalties. Other softer ways of influencing the governance of listed companies are seminars and workshops (Azerbaijan and Georgia).

\(^{22}\) For instance, one of the criteria to be calculated in the FTSE Frontier Index is having a clearing and settlement period shorter than T+7 and greater than T+1. FTSE indicates this as one of the market infrastructure elements required by international institutional investors.

\(^{23}\) There are 10 stock exchanges in Ukraine. PFTS, Ukrainian Exchange, and Perspektiva control 98% of the market volume. PFTS is under the control of Russian Micex.
input into capital markets legislation and regulation (KASE), the creation of websites for the dissemination of information, conducting evaluations of company websites, research, and the conduct of contests and competitions. Only two out of seven stock exchanges described having a formal programme dedicated specifically to advancing corporate governance. Despite the absence of formal programmes, respondents assessed themselves as actively pursuing and promoting better governance practices.

76. Seven out of 10 countries reported having corporate governance codes for listed companies. The ones that do not are Georgia, Kyrgyzstan and Uzbekistan though there is a code for banks in Georgia. (Mongolia, which did not respond to the survey, is an eighth country in the region with a voluntary corporate governance code). Four out of eight codes are mandatory. However, the questionnaire leaves open questions regarding what "voluntary" and "mandatory" mean. A comply or explain code may be considered voluntary in that compliance is up to the company. However, it can also be considered mandatory in the sense that disclosure of compliance (or non-compliance) is mandatory. Voluntary codes were reported in Belarus, Moldova and Tajikistan as well as two of the Ukrainian exchanges (PFTS and Perspectiva.) Mandatory codes were reported in Kazakhstan and at the Ukrainian Exchange. The code in Armenia is described as a mandatory comply and explain. Finally, the code in Azerbaijan is described as mandatory by the stock exchange and voluntary by the regulator.

77. In practice, governance codes and guidelines (even when voluntary) are implemented through the listing rules. In Moldova, the exchange tracks compliance of listed companies with the code and publishes its findings. In Kazakhstan companies are required to present their own governance codes as part of the listing process. Though exchanges enforce codes, none of the stock exchanges were issuing bodies of the national code and only four exchanges were actively involved in the elaboration of the code. This seems to indicate that exchanges are not the driving force behind codification efforts even if they may be a key to their implementation. Increasingly, exchanges and regulators are considering ways to both track and encourage compliance through the use of score cards. The IFC has been active in promoting scorecards throughout the region. Considering the active development of codes in the region, it may be worth assessing what their value has been and impact on corporate governance and capital market development.

78. All of the responding exchanges reported having multiple listing tiers. Five out of seven exchanges reported that corporate governance practices were a factor used to distinguish between the tiers. Only two exchanges (PFTS and Ukrainian Exchange) envisage using differential listing requirements to attract SMEs. The experience with SME listings has been both positive and negative in developed markets. The feedback regarding special SME listing appears to be muted among the group of Eurasian respondents.

**g. Shareholder Rights and Shareholder Participation in Governance**

79. Basic shareholder rights are well established throughout the region in the legal and regulatory framework, and are described in greater detail below. However, an important contextual consideration for the exercise of these rights is whether there are shareholders who are sufficiently informed and active enough to make use of these rights. In most developed markets and in a number of emerging

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24 These data combine responses from the regulator and exchange surveys along with supplementary research.
markets in other regions, institutional investors, particularly pension funds, are seen as the most likely candidates to exercise such rights in the interests of minority shareholders, for example to elect independent directors or to help ensure that the controlling shareholder and the board is acting in the company’s interest, rather than in the interests of the controller or parties related to the controller. However, within the Eurasian region, only in Kazakhstan were institutional investors mentioned as an important part of the capital markets. Kazakhstan has the highest proportion of institutional investors with approximately 6.5% in 2011 (down from 10.6% in 2010). This is modest compared to most OECD countries.

80. The virtual absence of institutional investors indicates that one of the key goals set by policy makers is not being achieved. The absence of institutional investors translates, obviously, into a loss of liquidity. However, in addition to money, institutional investors bring vibrancy and know-how to the markets. For example, in Kazakhstan institutional investors assisted in the revision of market legislation during the 2008 financial crisis which resulted in strengthened requirements for corporate governance. Pension funds and insurance companies ultimately played an active role in stabilizing the Kazakh financial market. In future, a number of countries may wish to consider pension reforms to foment greater participation of institutional investors.

81. The existence and protection of shareholder rights is considered as an essential condition for attracting institutional and foreign investors in support of capital market development. Some progress has been made in this regard, but gaps also remain. Five out of seven exchanges reported that they had listing requirements related to the protection of shareholder rights (PFTS in Ukraine and Moldova did not). In terms of meeting notice, the number of days given before a shareholder meeting ranged from a low of 20 days in Azerbaijan and Tajikistan to 45 days in Kyrgyzstan. Most are from 20 to 30 days, well within what could be considered good practice in developed capital markets. The information included in the meeting notice typically includes the date, time, and place of the meeting, the agenda and procedures. These too seem to correspond with normal practice in developed markets. Thresholds for requesting the convening of an extraordinary meeting of shareholders range from 10% to 25% of voting shares with the most commonly cited figure being 10%. The legal minimum quorum requirements range from 50% to 2/3rds of voting shares with most specifying either 50% or 60%.

82. Voting rights among survey respondents correspond well with best practice in developed markets. The two significant discrepancies are with respect to pre-emptive rights and proxy voting. In all countries that responded to the OECD survey, shareholders had the right to vote by proxy. However only three of eight allowed voting by mail, only one (Armenia) allowed voting by telephone or videoconference, and none allowed voting by e-mail or other electronic means. Furthermore, pre-emptive rights were available in four out of the seven countries. Pre-emptive rights are of fundamental importance to investors who do not want their ownership diluted. If the attraction of foreign institutional investors is a goal, then pre-emptive rights and proxy voting requirements will need to be strengthened.
Table 7. Shareholder Right to Vote on Key Issues

<table>
<thead>
<tr>
<th>Voting Rights</th>
<th>Frequency</th>
<th>Exception(s)</th>
<th>% vote required for approval</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Appointment of director(s)</td>
<td>7 out of 8 allow</td>
<td>Kyrgyzstan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(b) Removal of director(s) without cause</td>
<td>6 out of 8 allow</td>
<td>Kyrgyzstan, Tajikistan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(c) Removal of director(s) with cause</td>
<td>7 out of 8 allow</td>
<td>Kyrgyzstan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(d) Appointment of internal auditor(s)</td>
<td>7 out of 8 allow</td>
<td>Uzbekistan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(e) Removal of internal auditors</td>
<td>7 out of 8 allow</td>
<td>Uzbekistan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(f) Endorse the contract between the company and external auditor</td>
<td>6 out of 8 allow</td>
<td>Belarus, Kyrgyzstan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(g) Request termination of contract between the company and external auditor</td>
<td>6 out of 8 allow</td>
<td>Armenia, Kyrgyzstan</td>
<td>Simple majority</td>
</tr>
<tr>
<td>(h) Authorizing shares</td>
<td>6 out of 7 allow</td>
<td>Tajikistan</td>
<td>2/3 or ¾ supermajority</td>
</tr>
<tr>
<td>(i) Issuing shares</td>
<td>6 out of 8 allow</td>
<td>Armenia, Tajikistan</td>
<td>2/3 or ¾ supermajority</td>
</tr>
<tr>
<td>(j) Is the pre-emptive right the default rule?</td>
<td>4 out of 7 allow</td>
<td>Azerbaijan, Belarus, Uzbekistan</td>
<td>N/A</td>
</tr>
<tr>
<td>If so, can the existing shareholders vote for non-application?</td>
<td>2 out of 4 allow</td>
<td>Yes in Armenia, Yes in Tajikistan</td>
<td>N/A</td>
</tr>
<tr>
<td>(k) Amendments to company articles, charters, bylaws or statutes</td>
<td>All</td>
<td></td>
<td>2/3 or ¾ supermajority</td>
</tr>
<tr>
<td>(l) Remuneration of board members</td>
<td>All</td>
<td></td>
<td>Simple majority</td>
</tr>
<tr>
<td>(m) Major corporate transaction (acquisitions, disposals, mergers, takeovers)</td>
<td>All</td>
<td></td>
<td>2/3 or ¾ supermajority</td>
</tr>
<tr>
<td>(n) Transaction(s) with related parties that are material</td>
<td>All</td>
<td></td>
<td>2/3 or ¾ supermajority</td>
</tr>
<tr>
<td>(o) Changes to company business or objectives</td>
<td>7 out of 8 allow</td>
<td>Armenia</td>
<td>2/3 or ¾ supermajority</td>
</tr>
</tbody>
</table>


83. The counting of votes at shareholder meetings is in almost all cases done by counting commissions. Seven of eight countries reported having counting commissions (information provided by Uzbekistan was inconclusive). Counting commissions generally have a minimum of three people, and exclude management. In some cases, the role of the counting commission may be delegated to the registrar.

84. Shareholders in all respondent countries are allowed to directly nominate board members to the board of directors. In five out of eight countries there were specific thresholds for nominating board members. Thresholds range from 1% of total shares outstanding in Uzbekistan to 10% in Armenia.
with the most commonly cited threshold being 2%. Such thresholds appear to be in line with the practices of developed capital markets.

85. In all countries responding to the survey, shareholders were able to place items on the agenda of the shareholders meeting and make shareholder proposals. The percentage threshold of share ownership needed to make a shareholder proposal ranges from 1% in Kyrgyzstan and Uzbekistan to 5% in Ukraine with the most frequent threshold being 2%. In no country are there any items that are restricted from being put on the agenda.

86. One potential protection absent from the shareholder protection frameworks of all responding Eurasian countries is the use of voting caps for majority or controlling shareholders on any specific items at shareholder meetings. Voting caps are typically considered a protection for minority investors who might not be able to exercise any influence on issues that are of key concern to them. Detractors suggest that voting caps deviate from the principal of one-share-one vote and shareholder representation in direct proportion to share ownership.

87. Shareholder redress is another important issue. Shareholders throughout the region are able to seek redress if their rights are violated.

Table 8. Shareholder Redress

<table>
<thead>
<tr>
<th>Type of legal redress available to shareholders</th>
<th>Frequency</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Derivative Action</td>
<td>5 out of 8 permit</td>
<td>Azerbaijan, Moldova, Ukraine</td>
</tr>
<tr>
<td>(b) Direct individual action</td>
<td>All permit</td>
<td></td>
</tr>
<tr>
<td>(c) Class Action</td>
<td>6 out of 7 permit</td>
<td>Moldova</td>
</tr>
<tr>
<td>(d) Through the regulator acting on shareholder behalf</td>
<td>4 out of 8 permit</td>
<td>Armenia, Belarus, Tajikistan, Ukraine</td>
</tr>
</tbody>
</table>


88. In addition to the above, five out of eight respondents permit minority shareholders to inspect the books and records of the company (Armenia, Belarus and Moldova do not). In the case of Ukraine the right to inspect is interpreted as a right to audit and is reserved to shareholders holding 10% of the company’s shares and with the consent of the executive or the shareholders’ meeting. Such audit is to be paid by the minority shareholder.

89. Among the countries surveyed, all make insider trading illegal and provide for civil liabilities to offenders. Six of the seven respondents report fines for insider trading that range from USD 5,000 to USD 12,000. In Ukraine repeat offenders can be fined up to 300% of the gains generated from the insider trading transaction. Three out of six respondents reported the possibility of imprisonment for insider trading (Belarus, Moldova, and Azerbaijan) with sentences of 2, 6 and 10 years respectively. However, no data were obtained on actual cases of successful prosecution against insider trading or other abuse of privileged information. The credibility of enforcement capacity against market manipulation is a key issue and vulnerability for the building of investor confidence in Eurasian
markets, due to the greater ease with which share values can be manipulated in illiquid markets such as those in Eurasia.

90. All respondent countries require disclosure of related party transactions (though, according to Table 4 above, not all require disclosure in the annual report). In about half of the surveyed countries thresholds for related party transaction disclosure are set. In some countries the thresholds are denominated as a nominal amount (USD 7,600 in Azerbaijan) while in others the threshold is expressed in terms of a percentage of total assets. Here a low of 2% is cited in Armenia and a high of 30% in Tajikistan. A 30% threshold could be considered too high because it would effectively allow a major portion of corporate assets to be disposed of without triggering any disclosure.

91. In all cases (eight of eight countries) related party transactions must be approved by the board. Thresholds range from a low of 5% of total corporate assets in Azerbaijan to a high of 50% of assets in Kyrgyzstan. In most cases the general shareholders meeting can approve related party transactions once they exceed these thresholds. In either event, 50% of total company assets may set an unreasonably high threshold given that transactions of such size would likely result in a fundamental change the nature of the business.

92. Finally, no mention is made regarding whether related party board members must abstain from voting on transactions in which they are involved. Nor is there any mention of the particular role that independent board members might have in overseeing related party transactions. Both might be issues that merit further consideration, and may be areas where greater regulatory attention may be required, in particular given the history of related party abuses that occurred during mass privatization in some countries.

h. The Responsibilities of the Board

93. The minimum number of board members is specified in five of the respondent countries (Armenia, Azerbaijan, Kyrgyzstan, Moldova and Uzbekistan). Most set the minimum at three. Kyrgyzstan Armenia and Uzbekistan have a maximum board size of 11, 11 and 15 members respectively. Most often best practice suggests that smaller boards are better. However, boards can be too small as well. Clearly if a best practice board is to have a variety of experience and talents, if boards are to have the capacity for objective and independent judgement, and if boards are supposed to have specialised committees, then a board at the small end of the spectrum will not be able to deliver. The OECD survey focused on legal requirements; public information on the actual size of boards in the Eurasia region is not readily available.

94. Only Uzbekistan requires the representation of labour representatives on boards. Cumulative voting for the election of board members is permitted in all respondent jurisdictions with the exception of Azerbaijan. Of those reporting the right to cumulative voting, most (6) also indicate that cumulative voting is commonly used in practice. Four countries (Azerbaijan, Belarus, Kyrgyzstan, and Tajikistan) report term limits for board members. These range from one to three years. To the extent that term limits are not in place in the other countries, this may be an area requiring regulatory attention. Term limits along with limits on renewals can serve to prevent the entrenchment of board members.
Another area in which some limits may be called for is in the number of boards on which board members may serve. At present only Moldova limits its board members in the number of board positions they may hold (in this case to five). Excessive board memberships may not be as much of a problem in Eurasia as they are in some more developed capital markets. Furthermore, any potential regulation should avoid any action that might unduly diminish the potential pool of board members, in particular, independent board members. This being said, the problem of excessive memberships can emerge in future and may warrant attention.

With respect to board meetings, five out of seven respondents require quarterly meetings, i.e. four board meetings per year. Belarus has no direct requirement but can be understood to have a single meeting minimum because the board is required to elect the chairman of the board annually. For the group of country regulators as a whole, four meetings per year appear to be the commonly fixed minimum. None of the countries reported any limitations on the appointment of non-residents or foreigners to the boards of listed companies, and seven out of eight reported requirements to separate the position of the chairman of the board from the position of the CEO.

**Table 9. Requirements on Boards to Vote and Decide on Specific Issues**

<table>
<thead>
<tr>
<th>Boards are legally required to decide on:</th>
<th>Frequency</th>
<th>Exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Appointment and compensation of senior management</td>
<td>5 of 7 require</td>
<td>Belarus, Uzbekistan</td>
</tr>
<tr>
<td>(b) Review and adoption of budgets and financial statements</td>
<td>4 of 7 require</td>
<td>Kyrgyzstan, Ukraine, Uzbekistan</td>
</tr>
<tr>
<td>(c) Review and adoption of strategic plans</td>
<td>5 of 7 require</td>
<td>Belarus, Ukraine</td>
</tr>
<tr>
<td>(d) Major transactions outside the ordinary course of business</td>
<td>5 of 7 require</td>
<td>Armenia, Belarus</td>
</tr>
<tr>
<td>(e) Changes to the capital structure</td>
<td>3 of 8 require</td>
<td>Armenia, Azerbaijan, Belarus, Moldova, Ukraine</td>
</tr>
<tr>
<td>(f) Organization and running of shareholder meetings</td>
<td>All require</td>
<td></td>
</tr>
<tr>
<td>(g) Process of disclosure and communications</td>
<td>4 of 7 require</td>
<td>Armenia, Belarus, Ukraine</td>
</tr>
<tr>
<td>(h) The company’s risk policy</td>
<td>4 of 7 require</td>
<td>Belarus, Moldova, Ukraine</td>
</tr>
<tr>
<td>(i) Transactions with related parties</td>
<td>All require</td>
<td></td>
</tr>
</tbody>
</table>


Concerns regarding the professionalism of boards have been corroborated both through the World Bank corporate governance ROSCs (even if dated) and anecdotal evidence.
98. With respect to the board committees that are required by law, the audit committee is the most prevalent being required in five out of seven countries that provided information (Kyrgyzstan and Uzbekistan do not). There is, however, concern regarding the use of “audit commissions”. These are a feature of company in the former Soviet Union and elsewhere and are not true committees of the board. They are in fact constituted by outsiders who do not bear any ultimate responsibility for the performance of the enterprise. The use of remuneration and nominations committees is comparatively rare. Mongolia and Ukraine stand out as the only countries that require all three. It appears that at times board committees are established purely to comply with legal requirements. The survey was not able to provide information on whether board committees are actually functional, or whether they are established purely for compliance reasons, or the quality of their work.

99. Independent board members are not generally required (Armenia, Azerbaijan, Mongolia and Ukraine do). Azerbaijan and Ukraine set specific minimum numbers at 1/3rd and 25% of the board respectively. In Mongolia recent changes to the company law require for the first time that the board be composed of one-third of independent directors and that an independent member chair the audit committee. Armenia, Azerbaijan and Belarus report having definitions of board member independence embedded in law, regulation and/or listing requirements. With respect to the definitions of independence, in most cases they make reference to parties related to management and to shareholders, but less to employees of affiliated companies or individuals at companies having significant dealings with the subject company.

100. While the feedback from the respondents was not voluminous, there is cause to question whether current definitions of independence are sufficiently comprehensive and up to best practice in developed markets. A new consideration of definitions of independence must, of course, be put into the context of recent trends in developed markets to focus on a board member’s capacity for objective judgement rather than a mechanistic application of checklist definitions. This is particularly true in countries where the pool of qualified candidates for board memberships may be limited and where perfectly qualified individuals may be rejected based upon a technicality.

### i. Privatisation and Capital Markets

101. Raising funds and increasing the economic efficiency of state-owned enterprises (SOEs) have been considered the main objectives of governments for privatisation. The development of national stock markets through public offerings has also been a significant factor influencing privatisation initiatives (Meggisson and Bouchkova, 2000). Indeed, widespread privatisation transactions during the mid-1990s through stock markets provided the initial steps toward capital market development in the region.

102. However, actual developments fell somewhat short of expectations. According to studies, privatisation did not make a significant contribution to capital markets development especially in Central Asian economies (Conrad, 2008). One of the reasons may be that a significant part of the state-owned assets were withheld from flotation. In addition, inadequate attention may have been paid to privatisation techniques that would have better taken into account shareholder/market expectations and supported the development of stock markets. This being said, the potential to use SOEs as a tool to further encourage capital markets still exists as a substantial numbers of enterprises remain under state ownership in many Eurasian countries.
103. During the last decade, the USD 11.7 billion worth of privatisation transactions in the region have not had significant effects on stock market development. The exception is Kazakhstan where companies such as Kazakhtelecom, BTA Bank, Samruk-Kazyna Sovereign Wealth Fund, KazMunaiGas EP, NAC Kazatomprom, Kazakhstan Mortgage Company, and Mangistau Electricity Distribution Network Company were listed on the exchange.

104. Including KazMunaiGaz that was privatised through an IPO, the largest ten privatisation transactions represent 73% of total transactions between 2000 and 2008. The use of direct sales, auctions or tender methods for most of these transactions meant that they tended to lead to concentrated ownership rather than wide share ownership within local capital markets.

105. Significant recent developments in Kazakhstan’s privatisation plan, called the “People’s IPO Programme,” appear to be a starting point for a new phase of efforts to use SOE IPOs to support capital market development in the region. According to the programme presented to the Government by Kazakh SWF Samruk-Kazyna, some of the largest SOEs’ shares will be listed on KASE between 2012 and 2015. State oil transportation company KazTransOil, national grid company KEGOC and Air Astana have been announced as the first three companies to be listed on the exchange with a 5% -15% free-float ratio. The second phase of the programme will include national gas transportation company KazTransGas, state shipping company Kazmortransflot and state power asset management company Samruk-Energo.

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Sector</th>
<th>Name</th>
<th>Amount in US$ (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>196</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>191</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belarus</td>
<td>328</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td>1,822</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>3,039</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Moldova</td>
<td>46</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tajikistan</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>5,924</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>71</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>11,620</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: World Bank Privatisation Database
Note: The Database covers data on the sale price of privatisation transactions of over USD 1 million.

106. Mongolia has also proposed an IPO programme that will feature retention of 51 per cent of certain companies by the state, approximately one-third to be provided to private shareholders and,
originally, 10 per cent to be given to the public and to companies. However, this led to some people establishing companies simply for the purpose of obtaining partial ownership of state-owned companies, and so the government dropped the idea of providing ownership to the companies, and the IPOs still have not gone forward.

107. In addition to Kazakhstan and Mongolia, the OECD survey indicates that Armenia, the Ukraine Exchange and Ukraine’s PFTS have listed SOEs. These are the only exchanges to report any future plans to privatise SOEs through exchange listing.

4. Where to from here? Overall Assessment

108. The 2012 OECD survey asked respondents to identify the challenges that Eurasian exchanges and regulators face in developing their markets in order to identify remedies and potential actions. Survey respondents were able to clearly describe the weaknesses and also the strengths within their respective markets. While each country operates under different circumstances, some of the strengths and many of the weaknesses are shared.

Table 12. Strengths and Weakness in Eurasian Capital Markets

<table>
<thead>
<tr>
<th>Key Strengths</th>
<th>Key weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Established legal and regulatory frameworks even if some are in need of refinement</td>
<td>➢ Imperfections in the legal framework</td>
</tr>
<tr>
<td>➢ Some countries reported a significant number of market participants</td>
<td>➢ Limited number of market participants</td>
</tr>
<tr>
<td>➢ Growing and in some cases strong infrastructure</td>
<td>➢ Lack of infrastructure or insufficient development therein</td>
</tr>
<tr>
<td>➢ Emerging pension funds</td>
<td>➢ Local investment is limited to government bonds</td>
</tr>
<tr>
<td>➢ Presence of foreign operators such as NASDAQ OMX</td>
<td>➢ Low market capitalisation</td>
</tr>
<tr>
<td></td>
<td>➢ Limited fiduciary culture within boards and low awareness of capital markets among businesses and population</td>
</tr>
<tr>
<td></td>
<td>➢ Low financial literacy</td>
</tr>
<tr>
<td></td>
<td>➢ Disclosure and enforcement</td>
</tr>
</tbody>
</table>

109. The region paints a varied picture. Regulators are most likely to cite the need to improve regulation to bring it better in line with international standards. They also cite the need for better enforcement and implementation. Often mentioned is the need for greater cooperation with international organisations and donors. Exchanges on the other hand tend to cite the need for a better supply of companies and promotion of demand. Liquidity from investors is their main concern. Developing new instruments and stock exchange infrastructure is also mentioned.

110. Good corporate governance is recognised as an important part of the answer. Significantly, only one of the eight exchanges surveyed (PFTS) believes that a tightening of corporate governance
standards and tougher enforcement would discourage local listings. Similarly, only PFTS believes that local companies would delist or be dissuaded from going public if the exchange should raise its corporate governance requirements. This may be taken as a sign that good governance need not damage the local market. What seems to be important in judging the correct level of governance requirements is the ability of local enterprises to gradually adapt and comply.

111. Nor do exchanges feel that they compete based upon corporate governance requirements. This does not mean that there is no competition between exchanges; five out of eight exchanges feel that there is competition for listings with other regional exchanges and/or exchanges outside of the region. It does, however, suggest that the basis upon which exchanges compete is not regulatory or listing requirements. Much more likely competition is based on factors such as offering, market liquidity and the trading platform.

112. Good governance is recognised as an important factor but not a sufficient factor in the development of capital markets. Reforms need to be pursued simultaneously in a great number of areas for the capital markets to expand and flourish. Pension reform is expected to give impetus to the capital markets. Regional consolidation is also considered an important factor. Investors do not want to have to learn and obey a very large number of different and possibly contradictory rules and regulations. In fact, investors typically militate for as standardised of an approach as possible. All of the exchanges who responded to the OECD survey supported harmonisation of listing and other requirements to the maximum extent.

5. Issues for discussion and possible recommendations

Capital Markets in Eurasia: How to stimulate their growth?

113. Regulatory independence: Various measures have been put in place to give regulators a certain level of independence in setting policy. Independence can be seen in the regulator’s ability to control their own budgets, operational decisions and hiring. But there are doubts regarding the efficacy of such measures. To what extent are regulators truly independent? To what extent do the specific measures mentioned in the report work? Are they sometimes circumvented? What could be done to enhance regulatory independence?

114. Co-ordinated promotion of corporate governance and capital market development: Most promotion of corporate governance occurs in an uncoordinated fashion. Is there a need for more central direction, or, at least a regular and formal forum to discuss corporate governance issues and exchange information? Could the efficacy of existing efforts be thereby improved? Is there a need for additional institutions such as an institute of directors? What role should international and regional organisations such as the OECD, IFC, EBRD, ADB, FEAS or other institutions such as the Turkish Capital Markets Board and the Istanbul Borsasi provide to support corporate governance and capital market development?

115. Fines and penalties: Most Eurasian countries impose penalties for non-compliance with disclosure requirements that range from warnings and fines to a suspension of trading and eventual delisting. The level of fines, however, appears low, and reports of delisting may have more to do with removing defunct companies from trading rather than penalties. Do fines and other penalties have any
dissuasive effect? Are monetary penalties sufficiently high? Do potential prison penalties have more
effect? What part of companies that are delisted are as a penalty versus administrative house
cleaning? Do regulators and exchanges need greater powers/penalties?

116. Institutional investors: Foreign institutional investors are with some modest exceptions largely
absent from the region. What are the reasons they cite to explain their reticence? Why has it proven so
difficult to encourage greater participation? National institutional investors are arguably equally if not
more important. Some see the presence of local investors as a sine qua non to attracting foreign
investors and ensuring stable market conditions. In some countries pension reforms are creating local
liquidity. Have there been success stories with local pension and savings reforms? Is the role of local
institutional investors fully appreciated?

The Impact of Stock Exchanges on Corporate Governance

117. Consolidation and partnership agreements for exchanges: There is a trend towards the
international consolidation of stock exchanges. Two of the biggest players are the London Stock
Exchange and NASDAQ OMX. The methods for building relations between exchanges can range
from ownership to partnership agreements. In either case, international collaboration brings significant
advantages to local exchanges including access to technology, financial and intellectual capital,
standards and policies, and, perhaps, above all, credibility. Are relationships with foreign exchanges
seen as positive? Why or why not? Assuming such arrangements are positive, what factors stand in
the way of developing them further? Where are the business arguments more compelling: partnering
with experienced foreign operators or cementing relationships between nascent exchanges in the
region?

118. The independence of exchanges: Most exchanges report that they operate independently and are
able to engage in decision making independent of government intervention. None report conflicts of
interest with the state. On the other hand potential conflicts of interest are noted with private owners.
How independent are exchanges from the state in practice? If there is influence, what are the channels
of influence? How are the views of different stakeholders balanced? How seriously should the
potential conflicts of interest with private owners be taken? How are they best managed?

119. Stock exchange enforcement: Stock exchanges may be on the front line for enforcement of listing
requirements and with respect to the application of corporate governance codes, though in some
Eurasian countries these responsibilities are left to the responsible securities regulatory institution.
How effective are the exchanges in enforcing listing requirements? Are there incentives to keep
requirements and enforcement low in order to ensure a greater number of issues? Is the proper level of
rules and enforcement a question of properly balancing the need to attract listings versus the need to
ensure a credible capital market?

120. Corporate governance codes: Most Eurasian countries have corporate governance codes, and
many Eurasian countries have established mandatory requirements in relation to these codes.
Corporate governance codes that originated as voluntary codes of best practice in developed markets
may be enforced differently in Eurasia than in the countries where they originated. What does
mandatory mean in the Eurasian context? Does it refer to mandatory disclosure, or mandatory
compliance with the code? This also raises questions regarding the use of codes as a substitute for
substantive regulation. Is there a clear distinction between the role of law and the role of corporate governance codes? Are there deficiencies in law that are being addressed/masked by codes? Should some clauses in voluntary codes become part of the law? Alternatively, do some elements of mandatory codes need to be considered best practice, i.e. desirable but voluntary?

121. Exchange tiers and SME listings: In the past, exchange tiers have been suggested to encourage better corporate governance. Similarly, differential listing requirements have been suggested for SMEs. The use of tiers is limited by the number of companies already traded—multiple tiers may not make sense if the total number of companies is as limited as it is in the Eurasia region. Similarly, special SME rules depend on whether sufficient SMEs exist that would actually be interested in a potential listing. Are there sufficient numbers of listed companies to warrant tiers? Is there sufficient demand among SMEs and investor interest to warrant separate SME listing rules?

Corporate Governance Priorities for Capital Market Development

122. Accounting and audit: All of the countries in the region have engaged in significant reforms in the area of accounting and audit. IFRS and ISAs are the benchmark standards, and enabling statutory reforms have been made. The profession is also in evolution as are professional accounting bodies. Nevertheless, it appears that there are significant differences in the quality of the financial reports of locally-listed companies compared to companies who have listed on major foreign exchanges. Are there concerted and coordinated efforts to ensure that IFRS and ISA are applied as they are intended to be applied in the most developed markets? What barriers stand in the way?

123. Non-financial disclosure: Of all of the mandatory disclosures in financial reports, the ones that seem to be most lacking are non-financial disclosures and corporate governance disclosures in particular. What might explain the relative weakness of non-financial disclosure compared to more traditional financial reporting? What international reference points are used in developing local non-financial disclosure requirements?

124. Shareholder rights: Shareholder legal rights that determine participation in the affairs of the company appear to be largely in line with international practice. Two areas that might merit some concern are proxy voting and pre-emptive rights, neither of which is as fully present in law as other shareholder rights. Has there been feedback from potential investors suggesting that they want certain rights strengthened? If so, what are investors concerned about? Have pre-emptive and proxy voting rights been mentioned?

125. Related party transactions: Related party transactions, their monitoring and their disclosure are important issues in all countries, but particularly important in the wake of mass privatisation in Eurasia. Abusive related party transactions seriously damaged the reputation of a number of countries in the region. A number of issues bear consideration including: the disclosure of related party transactions in the annual report as required by IAS 24; whether the threshold for disclosure as required by IAS 24 is sufficiently low to meaningfully reveal conflicts of interest; whether the thresholds in legislation are sufficiently low; whether company governance structures and policies are sufficient to prevent abusive related party transactions to occur and to ensure that when they do occur that they transpire at arm’s length and in a transparent manner. Are related party transactions still a problem? How well do disclosure requirements work? Do boards have policies for monitoring and
authorising related party transactions in place? How well do such policies work in practice? Are past abuses still a concern for investors?

126. **Board governance practices:** Regulation of board member practices is a challenging and sensitive issue, considering the varying degrees of development of such boards in the Eurasian context. Determining the right balance for requirements versus voluntary best practice recommendations is a challenge requiring further consideration to address such questions as the most appropriate board size, lengths for board member terms, how to prevent board member entrenchment, how to ensure appropriate board member skills, limitations on other board memberships, the presence of foreigners on boards, the number of independent board members, committees, the minimum number of board meetings etc. A key question is whether law recognises “audit commissions” as true committees of the board. Is more detailed information on board sizes and other governance practices available? Is there a need for further study in this area? Should total number of board memberships be limited? Are there true audit committees in Eurasia or are structures really external audit bodies staffed by non-board members?

127. **Board responsibilities:** Boards are legally required to fulfil certain functions. These functions and responsibilities are typically laid out in law. The legal requirements of boards seem to fall short of what is seen in developed countries. There are other indications that boards do not act according to a developed country standard. Is there evidence that legal requirements correspond to those in developed markets? What powers do boards actually exercise in practice? How much assurance do boards provide to investors that shareholder interests are being pursued and protected?

128. **Board member independence:** The concept of independence on boards appears to have made limited inroads. Some laws set a minimum number of independent board members, but there is limited information on how such requirements are implemented in practice, whether independent board members are having an impact on board deliberations and whether insiders and shareholders appreciate their value. Are independent board members increasingly visible on boards? If so, are they accepted and how is their contribution perceived? Do mandatory requirements for independents work, or should it be left voluntary? Are current definitions of independence sufficiently flexible to allow for a sufficient pool of independents, or are definitions excessively flexible?

**State ownership and capital markets**

129. **State-owned Enterprise Listing or Privatisation:** Privatisation was used in the past to encourage the development of capital markets but with limited success. On the other hand, privatisation if handled effectively and equitably is considered as one of the best opportunities to develop the critical mass necessary for markets to take off and grow. Furthermore, and despite scandals associated with past privatisation programmes, listings can be the most transparent and safe way of privatising SOEs, especially if done in limited tranches. What can be learned from past initiatives? What should be done in future? Is there a critical mass of listings to support market development?
Annex 1 - Stock Markets in Eurasia

**Stock Market in Armenia**

- Market capitalization of listed companies (million, USD)
- Stock Trade Volume (million, USD)
- Number of Listed Companies

**Stock Market in Kazakhstan**

- Market capitalization of listed companies (million, USD)
- Stock Trade Volume (million, USD)
- Number of Listed Companies

**Stock Market in Georgia**

- Market capitalization of listed companies (million, USD)
- Stock Trade Volume (million, USD)
- Number of Listed Companies

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Source: Based on data from World Bank, FEAS and national stock exchanges.
## Annex 2: Stock Exchanges’ Infrastructure in Eurasia

<table>
<thead>
<tr>
<th>Country</th>
<th>Stock Exchange</th>
<th>Instruments</th>
<th>Central Depository</th>
<th>Settlement Period</th>
<th>Restriction to Foreign Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>Nasdaq OMX</td>
<td>Stocks, Corporate Bonds, Government Bonds, Repo, Foreign Currency, Interbank Credit</td>
<td>Yes</td>
<td>T+0</td>
<td>No</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Baku Stock Exchange</td>
<td>Treasury Bonds, Central Bank Notes, Stocks, Corporate Bonds, Repo</td>
<td>Yes</td>
<td>T+0</td>
<td>No</td>
</tr>
<tr>
<td>Belarus</td>
<td>Belarusian Currency and Stock Exchange</td>
<td>Stock, Currency, Futures</td>
<td>Yes</td>
<td>T+0</td>
<td>No</td>
</tr>
<tr>
<td>Georgia</td>
<td>Georgian Stock Exchange</td>
<td>Stocks</td>
<td>Yes</td>
<td>T+1</td>
<td>No</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>Kazakhstan Stock Exchange</td>
<td>Stocks, Bonds, Foreign Exchange, Derivatives, State Securities</td>
<td>Yes</td>
<td>T+0</td>
<td>No</td>
</tr>
<tr>
<td>Kyrgyz Rep.</td>
<td>Kyrgyz Stock Exchange</td>
<td>Stocks, Bonds, Treasury Bills</td>
<td>No</td>
<td>T+3</td>
<td>No</td>
</tr>
<tr>
<td>Moldova</td>
<td>Moldovan Stock Exchange</td>
<td>Stocks</td>
<td>Yes</td>
<td>T+3</td>
<td>No</td>
</tr>
<tr>
<td>Mongolia</td>
<td>Mongolian Stock Exchange</td>
<td>Stocks, Government and Company Bonds</td>
<td>Yes</td>
<td>T+1</td>
<td>No</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Ukrainian Exchange</td>
<td>Stocks, Bonds, Options</td>
<td>Yes</td>
<td>T+5</td>
<td>Yes</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>Tashkent Republican Stock Exchange</td>
<td>Stocks</td>
<td>Yes</td>
<td>T+5</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Federation of Eurasian Stock Exchanges.
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