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***SHAREHOLDER RIGHTS, EQUITABLE TREATMENT
AND THE ROLE OF THE STATE***

Kazakhstan

By

**Mr. Aigoul Kenjebayeva
Salans Hertzfeld & Heilbronn**

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Shareholder Rights, Equitable Treatment and the Role of the State in Kazakhstan

Introduction

After gaining its independence in 1991, Kazakhstan has put significant effort into the development of a legislative framework regulating the corporate ownership structure necessary for the creation of a dynamic market economy. The first Kazakhstan law “On Business Partnership and Joint Stock Companies” was adopted on 21 June 1991.¹ Since then the laws governing the creation and functioning of legal entities, including joint stock companies, has been changing and growing along with the successive development of the country’s economy.

At the moment the main legal acts regulating the formation and operation of joint stock companies are: the Civil Code and the Joint Stock Company Law. At present a new draft Joint Stock Company Law has been prepared and submitted to the Mazhilis (the lower house of the Parliament). The draft was prepared by the RK National Bank and according to its explanatory note, aims to further develop the concept of joint stock companies and improve the national securities market.

According to the existing legislation, a joint stock company (hereinafter - JSC) is a legal entity issuing shares in order to raise funds for its operations. As a legal entity, the JSC may in its own name acquire and effectuate property and personal non-property rights and duties and is liable to the extent of such property for its own obligations; it can be plaintiff and defendant in court. A JSC is not liable for the obligations of its shareholders.

The existing law distinguishes between open and closed type JSCs based on the means of placement and alienation of shares and overall number of shareholders. A closed JSC can place its shares only among its shareholders and a predetermined group of persons. The number of shareholders of a closed JSC cannot exceed 100 (except for non-profit organizations). Shareholders of a closed JSC have the right of first refusal to acquire shares sold by other shareholders in the company, while the shareholders of an open JSC do not need the consent of other shareholders to alienate their shares.

The existing JSC law also provides for an open “public” JSC: i.e., one whose shares are quoted on an organized securities market, has at least five hundred shareholders and whose assets are worth more than approximately USD 1mln. The legislative intent was that such “public” companies were to be more transparent in their activity. Thus, the law provides additional requirements for such public companies to publish financial statements, notify authorized governmental body on significant changes in activities, etc. This transparency is supposed to be one of the mechanisms to protect shareholders’ rights. However, in practice JSCs do not seek to obtain the status of “public” companies because they gain no actual privileges, but incur additional obligations to disclose financial information.

¹ The Law of Kazakhstan SSR “On Business Partnerships and Joint Stock Companies” of 21 June 1991;

In order to operate more efficiently in the market or the management of business, companies often create corporate groups on a temporary or permanent basis to achieve a one-time purpose or to form a durable partnership. Such corporate groups may exist as holding and affiliate companies or consortium of the companies. In reality there is a trend toward the formation of such corporate groups, especially for operating large-scale projects, such as those involving natural resources. The civil legislation also provides that commercial organizations may create unions and associations which are non-commercial organizations for the purpose of coordinating their entrepreneurial activity and defending common interests.

1. Protection of shareholder rights

The JSC law stipulates the basic shareholder rights and provides that those rights may not be restricted by the provisions of the charter or the decisions or resolutions of the management bodies of the company. Provision of the charter or resolutions of management bodies in violation of these basic rights are invalid. Any shareholder whose rights are infringed can seek protection in the courts or in certain cases in authorized governmental bodies.

The basic shareholder rights are to (i) participate in the management of the company; (ii) receive dividends; (iii) obtain information on the company's operations, including the right to review the company's financial reports according to the procedure established by the general meeting of shareholders or the company's charter; (iv) obtain extracts from the register-holder or nominee holder (licensed broker-dealer, custodian) which certify the shareholder's right of ownership to his/her securities; (v) challenge in court resolutions adopted by the company's bodies; (vi) apply to state agencies for the protection of shareholder's rights and lawful interests when the company's management bodies commit actions which breach the requirements of legislation or the company charter; (vii) direct written inquiries to the company regarding its operations and to receive substantiated responses within thirty day of receipt of the inquiry by the company; and (viii) receive a part of the assets remaining after the liquidation of the company.²

In addition to these basic rights, other specific shareholders' rights may also be provided for in the charter of the company, by a decision of the general meeting of shareholders.

a) Ownership rights

The basic rights of shareholders are to receive a portion of the net profit of the JSC in the form of dividends, to participate in the management of the company and to receive a part of the assets remaining after the liquidation of the company. The shares of the company are the securities that confirm these rights.

The JSC can issue common and/or preference shares. The JSC can issue two types of preferred shares: (i) non-voting shares with a minimum fixed amount of dividend; and (ii) voting shares with a minimum fixed amount of dividend.³

² Article 14.1 of RK Law "On Joint Stock Companies" of 10 July 1998 (the JSC Law);

³ Article 24.2 of the JSC Law;

The issuance of shares (and other securities) by the JSC must be recorded in a register of securities holders of the company. Furthermore, all transactions involving shares and other securities of a company must also be registered with the register-holder. This requirement provides that all shareholders may prove their rights to shares. Any shareholder (owner, nominal holder of shares, or pledge holder) has a right to request the register-holder to provide an extract from the register which certifies that shareholder's right of ownership (or other rights) to the securities.⁴

The JSC must ensure the establishment of the securities holders registry not later than one month after the State registration of the company. The register can be kept by an independent registrar or by the JSC itself, provided it has a specialist who holds a proper qualification certificate (except for open JSCs with more than five hundred shareholders which must keep their registers with an independent registrar only).⁵

The register is an official list of securities holders compiled for a certain date which identifies the holders as well as the type, nominal value, and the amount of securities owned by them. The register allows interested parties to identify registered securities holders and securities transactions registration. The registry exists in the form of book entries as well as in electronic format (electronic entries) and must meet certain mandatory requirements set forth by the legislation.

The documentary confirmation of one's right to a security can be either the security certificate itself or an extract from the register of securities holders.⁶ For non-documentary securities this may be done by way of an extract from the register of securities holders or a report of the nominee holder's account (issued by a licensed broker-dealer or custodian). The Law allowing securities to be issued in non-documentary forms only when a JSC has more than five hundred shareholders and when its shares are traded on an organized market.⁷

b) Dividends

The decision whether the JSC is to pay dividends is to be adopted by the general meeting of shareholders or board of directors. Dividends can be paid on a quarterly or semi-annual basis, or according to it's the company's annual earnings.⁸ The amount of dividends accrued per share is usually established by the board of directors of the company, unless otherwise stipulated by the company's charter.

The shareholders will not be paid dividends if the general meeting of shareholders or the board of directors of JSC resolve that it is inadvisable to pay dividends on common shares because of annual earnings or unfavorable results of any other period.⁹

Furthermore, the law prohibits paying dividends to shareholders on common shares for the following year when the company's equity capital is negative or if the company shows signs of

⁴ Article 38 of the JSC Law;

⁵ Article 35.1 of the JSC Law;

⁶ Article 38.2 of the JSC Law;

⁷ Article 36.2 of the JSC Law;

⁸ Article 19.2 of the JSC Law;

⁹ Article 19.3 of the JSC Law;

insolvency or impending bankruptcy, or if such signs would appear in the company after the announcement and payment dividends. Payment of dividends in violation of this rule can be considered an infringement of the rights of the company's creditors and may be invalidated in court pursuant to an action brought by any concerned party.¹⁰

The shareholders of a non-commercial organization established in the form of a JSC are not to receive dividends even if the company is in good financial state and has profits. The law imposes this restriction because the essence of a non-commercial organization is not to gain profit for its founders, but to serve other purposes for which it was established.¹¹

Dividends on common shares shall not be paid until the dividends payable to holders of preferred shares have been paid in full. Shareholders holding preferred shares have a priority right to receive dividends before owners of common shares at the predetermined, guaranteed rate established by the share issue prospectus. Unpaid dividends on preferred shares must be accumulated and paid upon the expiration of the designated dividend payment term in accordance with the issue prospectus. The rate of dividends on preferred shares may not be less than the amount accrued on common shares for the same time period.

In addition, dividends shall not be paid on shares which have not been paid in full, on shares which have not been issued or placed or which were repurchased by the company.¹² Also, shares which have not been paid for in full or which have been repurchased by the company have no voting rights.¹³

A JSC may repurchase its shares in order to redistribute or cancel them or for other grounds stipulated in the company's charter. In order to protect shareholders rights, the law stipulates that if a JSC offers to repurchase more than one percent of issued shares, the offer must be equally accessible to all shareholders with respect to price and repurchase conditions and must be announced in an approved publication. The quantity of shares repurchased by a company may not exceed twenty-five percent of the total number of shares issued by the company, while funds allocated by the company to repurchase shares may not to exceed ten percent of the company's equity capital.¹⁴

c) Participation in major corporate changes

One of the basis shareholder rights is the right to participate in the management of the company. This right is exercised by participating in the general meetings of shareholders - the main governing body of the JSC and other management bodies. The general meeting of shareholders is authorized to decide any issue of the JSC's operation. Moreover, certain issues can only be decided at the general meeting of shareholders and cannot be delegated to other managing bodies of the JSC. The law stipulates that the following issues shall be within the exclusive jurisdiction of the general meeting of shareholders: (i) amendment of JSC's charter; (ii) changing the type of the company; voluntary reorganization and liquidation; (iii) changing the size of the company's

¹⁰ Article 20 of the JSC Law;

¹¹ Article 19.6 of the JSC Law;

¹² Article 19.5 of the JSC Law;

¹³ Article 27.6 of the JSC Law;

¹⁴ Article 28 of the JSC Law;

authorized charter capital; splits and/or consolidation of shares; the procedure for distribution of the company's net income; approval of the amount of dividends of the annual results; adoption of a resolution for the company to participate in the foundation or activities of other legal entities by transferring a portion of its assets in an amount comprising twenty-five percent or more of all the assets belonging to the company; approval of major transactions; the conditions and procedure for the issuance of company bonds and derivative securities; adoption of a resolution to increase the company's liabilities in an amount comprising twenty-five percent or more of the size of the company's equity capital; and (iv) election of the board of directors, audit commission and early termination of their powers.¹⁵

The resolution to amend the company's charter, to change the type of company and voluntary reorganization or liquidation must be adopted by a qualified majority of the voting shares in the company. Resolution on other issues may be adopted by a simple majority of the total number of voting shares in the company which participated in the voting, unless the company's charter stipulates a larger number.

d) Shareholders meetings and access to information

The JSC is obliged to hold a general meeting of shareholders annually.¹⁶ General meetings of shareholders other than the annual meeting are known as extraordinary meetings which can be convened on the initiative of the board of directors, executive body or audit commission of the company or initiated by shareholders holding in total five percent or more of the voting shares of the company or by a liquidation commission (if the company is in the process of voluntary liquidation).¹⁷ If the board of directors or executive body refuses to convene a general meeting of shareholders, these other bodies may appeal the decision in court and the meeting will be convened by court order.

During voting at the general meeting, each shareholder has a number of votes equal to the number of voting shares belonging to him/her, except in cases where a differed procedure for determining votes is provided by the company's charter. Shareholders who hold non-voting preferred shares may attend the general meeting and take part in the discussion of issues on the agenda. Non-voting preferred shareholders acquire right to vote at a general meeting of shareholders when dividends on such shares are not paid within three months of the designated payment date until the overdue dividends have been paid.¹⁸ Voting at the general meeting of shareholders may be either open or by secret ballot and is conducted on the principle of "one share – one vote", except in cases where cumulative voting is held for the election of members of the company's board of directors, executive body and audit commission.

The list of shareholders entitled to take part in the general meeting shall be drawn up on the basis of the data in the company's shareholders' register. Shareholders must be informed about the meeting by written notice and /or through the publication of an announcement in an approved publication no later than 30 days in the case of an open JSC or 15 for a closed JSC.¹⁹ According to

¹⁵ Article 48 of the JSC Law;

¹⁶ Article 47.1 of the JSC Law;

¹⁷ Article 49 of the JSC Law;

¹⁸ Article 24.3 of the JSC Law;

¹⁹ Article 51.2 of the JSC Law;

the law the materials provided to shareholders must contain all the information required to make a decision during the voting. If the shareholder desires, the company must give him/her an opportunity to review such materials in a place determined by the company. Materials to be provided to shareholders in the course of preparing for an annual general meeting must contain the basic data on the company's annual report to be approved, the auditor's report on the results of the annual audit of the company's financial and business activity, and other information concerning agenda issues.

The agenda may be amended if shareholders holding a total of ninety-five percent or more of the voting shares in the company taking part in the meeting agree.²⁰ Additions to the agenda in the published announcement and/or notice may be made by the proposal of shareholders holding a total of five percent or more of the voting shares no later than ten days before the date of the meeting.

The general meeting is authorized to adopt resolutions if by the end of the registration of the general meeting participants, shareholders holding a total of fifty or more percent of the voting shares in the company have registered and are present. Any shareholder can participate in and vote at the general meeting in person or through a proxy who acts on the basis of a properly issued power of attorney. However, the law restricts the JSC's officers from acting as shareholders' proxies at the meeting.

2. Equitable treatment of shareholders:

The basic principle of the JSC concept is the equality of its shareholders in the management of the company and property rights. A share gives the same right to each shareholder. In reality, of course, the shareholders having more shares than others have more rights and can influence the activities of JSC and decisions of JSC in their interest, which can impinge interests of other (minority) shareholders.

a) Treatment of minority shareholders;

The law does not give an definition of minority shareholders as such, however, from the provision of the law granting certain additional rights to shareholders holding more than five percent of the shares, we can draw the conclusion that shareholders holding less than five percent of the company can be considered minority shareholders.

In order protect minority shareholders, the law provides "cumulative voting" and "independent directors." According to the law, "cumulative voting" allows the minority shareholders to jointly participate by way of voting in the operation of the general meeting of shareholders and thus the management of the company. Cumulative voting gives the minority shareholders certain additional rights when joining together, such as convening meetings of the board of directors, requests to audit the activity of the company's executive body and having a representative in the liquidation commission.

²⁰ Article 51.5 of the JSC Law;

In order to furnish an opposition to the members of the board of directors whose interests do not coincide with the interests of minority shareholders, the law provides that not less than fifty percent of directors of “public” companies must be “independent directors”. An independent director is defined as “a member of the board who is not and has not been an officer of the JSC or affiliates thereof, or an auditor and /or consultant of the JSC for the five years preceding his/her election to the board of directors, and who has not been involved with any other affiliate of the JSC and is not linked by subordination or kinship to officers of the aforesaid organizations.”

The law also provides rules that protect shareholders when large blocks of shares are being alienated. When 30 percent or more of the voting shares are being transferred to a third party (including affiliated entities), other shareholders have a right to demand that such shareholder purchase their shares at the market price.²¹ If this rule is not complied with, the entity/person holding a large block of shares must sell its shares in excess of twenty-nine percent of the total shares of the company.

Shareholders, including minority shareholders, may demand that the JSC purchase their shares when the company is being reorganized, entering into a major transaction, or amending its charter so as to restrict the shareholder’s rights, if the shareholder voted against the adoption of such resolution or did not take part in the general meeting of shareholders at which the resolution was adopted.²² The shareholder has the right to appeal in court against the company’s refusal to repurchase shares or when he/she is not agree with repurchase price.

Another important instrument to protect minority shareholders right is the special procedure for conducting “major transactions.” According to the law, a major transaction is a transaction or several interrelated transactions involving the acquisition or alienation by the company, directly or indirectly, of a total value of twenty-five percent or more of the assets of an open JSC or ten percent or more in the case of a public company (including transactions involving the repurchase or sale, issuance and distribution of company securities). The decision to enter into a “major transaction” is to be taken at the general meeting of shareholders. A shareholder who did not participate in the voting or who voted against the decision to enter into a major transaction may demand that the company repurchase his/her shares.

b) Treatment of foreign shareholders

The legislation does not provide any generalized rules for foreign entities who are shareholders in a JSC established in accordance with Kazakhstan legislation. Therefore, the rights and obligations of foreign entities and individuals are regulated in accordance with the rules of the JSC law and Kazakhstan laws. However, the legislation does contain certain restrictions on ownership of shares by foreigners in mass media (up to 20 percent) and in constructing companies (up to 49%). Also, foreign entities may not be founders of private security organizations.

c) The State as a shareholder.

²¹ Article 29 of the JSC Law;

²² Article 28.6 of the JSC Law;

The State exercises its share ownership rights through a special State body – the RK Ministry of Finance Department of State Property and Privatization and its local departments. The shares of municipal companies are managed by the local executive authorities –Akims.

Shares can also belong to a State enterprise. In this scenario, the State enterprise has a right to participate in the management (vote at the meeting of shareholders, be on the board of directors, etc.) of the JSC and receive dividends, however the right to dispose of the shares remains with the Department of State Property and Privatization.

The State representative managing the State's block of shares must protect the interests of the State by participating in the voting of the management bodies of the JSC and has the right to appeal to a court of law as a shareholder as well as exercise other shareholders rights provided by the law.

It is noteworthy that the State (State enterprise) as shareholder has the same rights and obligations as any other shareholder and the law does not provide privileges for the State as shareholder.

3. Violation and abuse of shareholders rights

The most frequent shareholder right violations include infringement of shareholders' rights by the management of the company, such as the board of directors or the executive body of the company when they exceed their powers in alienating assets, maintaining the JSC register, providing access to information and financial reporting, etc. Abuses also occur in providing true information about major transactions or related-party transactions.

a) Assets stripping and self dealing

The management bodies of the JSC, such as the board of directors or executive body (a president or management board) carry out the general day-to day management of the company and can enter into transactions on behalf of the JSC within their authority. In practice, sometimes such management bodies enter into agreements in excess of their powers and thus infringe the interests of the JSC and its shareholders. In order to protect the shareholders, the law sets forth the list of issues that can only be resolved at the general meeting of shareholders, in particular, transfers of assets in an amount comprising 25 or more of all the assets belonging to the company when establishing or participating in other legal entities, or increasing the company's liabilities in an amount of 25 percent or more of the company's equity capital. "Major transactions" must also be approved by the general meeting of shareholders.

b) Related party transaction

The law stipulates special requirements for concluding transactions in which the officers of the JSC (members of the board of directors, management board or president), and any shareholder holding jointly with its affiliates ten percent or more of the voting shares in a non-public company or five percent or more of the voting shares in a public company have an interest.²³ The resolution to enter into a related party transaction must be adopted by the company's board of directors by the majority of the members who do not have an interest in the execution of the transaction in the

²³ Article 81 of the JSC Law;

case of an open JSC, or by the majority of votes of the independent directors in the case of a public company. In certain cases, decisions to conclude “interested party” transactions must be taken by the general meeting of shareholders.

In practice, the violation of the rules for concluding related transactions entail serious consequences for JSCs and even lead to their bankruptcy or the officers or other interested parties having to compensate all losses cause by their actions.

According to the law, related party transactions concluded in violation of the requirements of the law are invalid and the interested entity is liable to the company for losses caused to it. When such transaction was executed by several persons, their liability to the company is joint and several. Transactions concluded in violation of this requirement shall be invalidated by court order.²⁴

c) Insider trading and share dilution

The legislation does not have a provision protecting shareholders from insider trading and share dilution This probably due to the fact that the securities market is not very well developed in Kazakhstan. Since the draft new law on joint-stock companies aims to develop the securities market, it would be helpful to include such provisions therein.

4. Enforcement and legal redress

a) Regulatory enforcement

In order to protect their rights, shareholders can appeal to the courts. Rights may be upheld by a court by express declaration, restoration of the situation which existed before the violation occurred, invalidation of actions which violated the right or created a threat of violation, ordering specific performance of a duty, recovery of losses or imposition of a penalty, reversal of a transaction, punitive damages to reflect moral injury; termination or alteration of legal relations or other means.²⁵ Shareholders may petition a court to challenge decisions or invalidate transactions entered into by the management bodies that infringe their rights.

In certain cases shareholders may also appeal to State agencies (the Securities Department of the National Bank). The National Bank is an authorized state body regulating the securities market. The Bank is empowered to protect rights and lawful interest of investors (including shareholders) in the securities market. For this purpose the Bank has the right to request State bodies and other securities market participants, including JSCs, to furnish any information it considers necessary in order to carry out its monitoring functions as well as issue regulations mandatory for all participants of the securities market. However, the Bank has jurisdiction over securities matters only (securities issue, placement, operations of register-holders, brokers, etc.). Other JSC operations issues are outside its authority. In any event, filing a complaint with the Bank does not deprive shareholders of the right to petition the court concerning the same matters.

5. Shareholder awareness and shareholder association

²⁴ Article 84 of the JSC Law;

²⁵ Article 9 of the JSC Law;

It is no exaggeration to say that shareholders are barely aware of their rights, especially individuals who obtained their shares as a result of privatization. In such cases, ten percent of the shares were usually given to the workers of the privatized companies. On the other hand, large individual shareholders and legal entity – shareholders are usually well informed about their rights.

We would hope that the RK Government, within the framework of its legal reform programs, would devote particular attention to better informing individual shareholders of their legal rights.

Conclusions

The current JSC was fairly well drafted, although often in practice the law is not applied as written. Part of the problem is that the majority of shareholders are not well informed about their rights.

As we already stated above, at the moment a Draft JSC Law is being discussed in the Parliament. The main innovations proposed in the draft are that it eliminates the closed/open joint stock company difference and replaces it with an “AO” i.e., a “Shareholder Company” and significantly increases the minimum charter capital- from 100 Monthly Calculation Indices (about \$540US) to 200,000 Monthly Calculating Indices (over \$1 million US). We believe that by way of these changes the legislators intend to decrease the number of small businesses existing in the forms of joint stock companies and have a smaller number of large joint stock companies the shares of which would be attractive to investors in the stock exchange. For the same purpose the draft law provides for greater transparency in a company’s financial dealings, reports to stockholders and potential investors. The draft law also improves certain provisions of existing legislation, for example, those concerning related party transactions and disclosing information affecting the interests of shareholders.

However there also are negative aspects of the draft law which may lead to shareholders rights impediments. For example, the new draft law does not contain a clear provision for the procedure to establish share prices for repurchase at the request of the shareholder. This may lead to violations of shareholders’ rights and multiple court disputes.

Furthermore, adoption of this new law would entail the re-formation and re-registration of existing JSCs into other forms of enterprise such as LLPs. Apart from the expenses for re-registration, reorganization may pose bigger problems involving violation or distortion of rights of shareholders when transforming shares and other securities into interests in other forms of enterprise (such as LLPs). Unfortunately, the draft law does not provide any mechanism for resolving such problems.

Annex:

Principal laws and normative acts

1. RK Law “On Joint Stock Companies” of 10 July 1998;
2. RK Law “On the Securities Market” of 5 March 1997;
3. RK Law “On Competition and Restriction of Monopolistic Activities” of January 2001;
4. Decree of the RK Government “On Certain Issues of Additional Issuance of Shares of Joint Stock Companies” of 7 June 1999 # 707;
5. Decree of the RK Government “On Issues of Additional Issuance of Shares of Joint Stock Companies” of 4 May 2000 # 656;
6. Resolution of the National Securities Commission “On the Procedure for Registration and Invalidation of Shares Issuance and Approving Reports on Issuance and Placement of Shares in the Republic of Kazakhstan” of 29 November 1996 # 141;
7. Resolution of the National Securities Commission “On the Procedure for Offering Shareholders to Use the Preemptive Right of Share Purchase” of 23 February 1999 # 23;
8. Resolution of the National Securities Commission “On the Procedure for Participation of Joint Stock Companies in the Charter Capital of Other Legal Entities Through Transferring their Assets” of 22 July 1997 # 106;
9. Resolution of the Board of Directors of the National Securities Commission “On Certain Issues of Distribution and Payment of Dividends” of 18 March 1999 #261;
10. Resolution of the Board of Directors of the National Securities Commission “On Terms for Acquiring Large Share Holdings” of 26 October 1998 # 182;
11. Resolution of the Board of Directors of the National Securities Commission “On the Procedure for Notification of Acquisition of Shares of an Open Public Company” of 3 November 1998 #187;
12. The Decree of the State Committee on Pricing and Anti-Monopoly Policy “On the Procedure for the Approval by Anti-Monopoly Bodies of the Draft Agreements on Merger of Joint Stock Companies” of 29 July 1996.