Capital Markets in Eurasia: Two Decades of Reform

- First Draft-

Background Paper

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

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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 Afghanistan, 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 will build 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.

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, while stock exchanges in the Middle East and North Africa (MENA) region along with some other developing countries' exchanges are still state-owned and take part in long-standing privatisation programmes, most countries in the region have established stock exchanges based on a private company model format.

2. 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].

3. 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, banks etc. On the other hand, weak implementation and enforcement is still the case across the region.

4. 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.

5. This paper is intended to provide a first background to the initial meeting of *the Group,* by discussing the links between corporate governance, capital markets and economic development and addressing the current capital markets landscape of the region based on available research. The paper also provides some tentative proposals for *the Group*'s further reflection and focus. However, obtaining more direct input from policy-makers, regulators and other stakeholders in the region during *the Group*'s first meeting and through a follow-up questionnaire to be disseminated to all countries

[1] In terms of total market capitalisation of local listed companies (World Bank Development Indicators).

[2] Shifting wealth: refer to OECD's Perspectives on Global Development 2010: Shifting Wealth

after the meeting will be crucial to the further development of this report. This input will be sought in order to elaborate on the challenges and priorities identified by *the Group* with regard to corporate governance and its role in capital market development and economic growth in the Eurasia region.

6. 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 overview of the macroeconomic situation of the region over a twenty-year perspective. Section 3 presents the size of capital markets and the capital market regulatory and stock exchange environment of the countries in Eurasia. Furthermore, it also reviews the privatisation implementation of Eurasian countries with a link to capital markets. Section 4 concludes with proposed topics that could be addressed in the further version of the paper for the second meeting of *the Group* in 2012.

1. Corporate Governance, Capital Markets and Economic Growth

7. 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.

8. 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."*

9. The Eurasia Corporate Governance Roundtable's *Corporate Governance in Eurasia: a Comparative Overview* (OECD 2004) pointed to several elements of corporate governance that are important to improve company performance, attract investment and spur economic growth in the region.

10. First, it is important when considering corporate governance models for the Eurasian region to tailor these models 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 that ultimately resulted in the creation of companies dominated by controlling shareholders, with low liquidity and little trading volume among the remaining dispersed, individual shareholders. In the absence of a culture among minority shareholders to play an active role in monitoring their investments, the monitoring of management and corporate performance came to rest with the largest, usually controlling, shareholders.

11. The predominant role of controlling shareholders and low liquidity in developing and emerging markets is also associated with certain risks, notably the risk that the dominant shareholders may expropriate funds at the expense of minority shareholders through abusive related party transactions, self-dealing, tunnelling or other means.

12. 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.

- ***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.

13. The *Comparative Overview* concluded that Eurasian markets were not yet performing the key functions necessary to provide a viable alternative to bank funding for debt and equity financing and of offering a secondary market in ownership. The Roundtable in its second phase therefore

concentrated specifically on a joint initiative with the EBRD to promote better corporate governance of banks as one of the leading sources of corporate finance in the region.

14. In addition, private equity, venture capital and other funding vehicles have also played a growing 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.

15. Yet, a number of emerging markets in other parts of the world have experienced more 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 in 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 section 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.

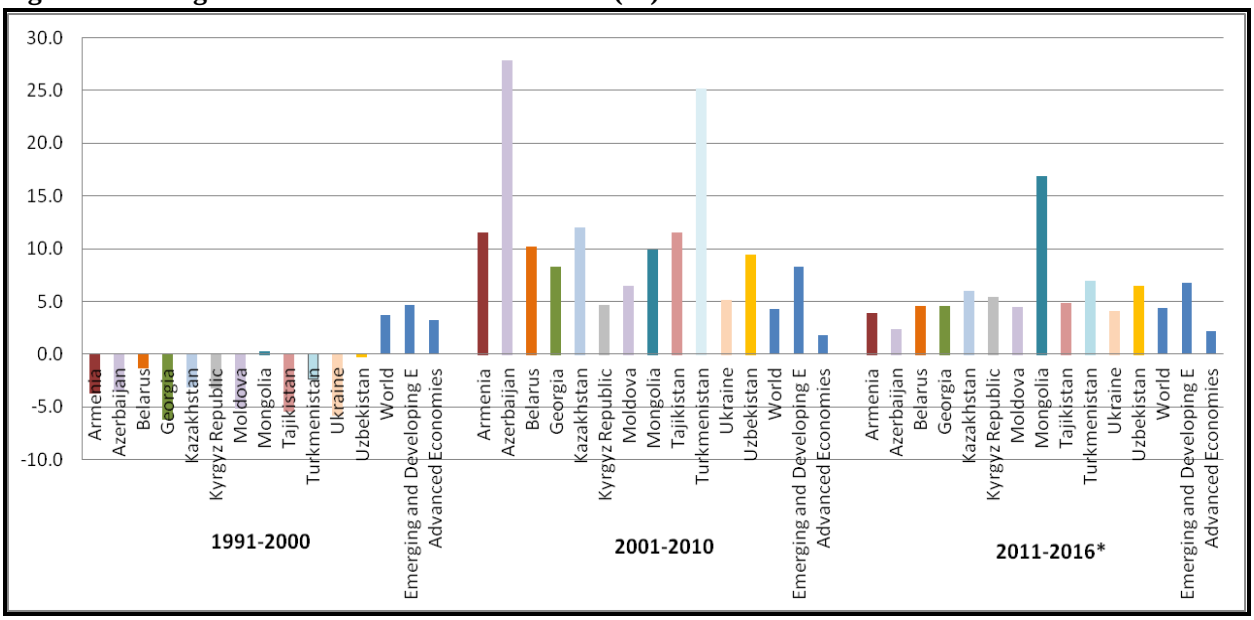
2. Macroeconomic Overview of the Region

16. 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 Mongolia (0.3%). 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.

17. In addition, considering the strong relationship between national savings and economic growth, the high national saving ratios have enabled 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).

18. However, recent IMF estimates suggest that it is unlikely that the region will be able to sustain these high levels of savings and growth in the coming period. The IMF has estimated that in some countries (Azerbaijan, Kazakhstan, Mongolia and Uzbekistan), the gross national savings as percent of GDP will shrink during the next three years. Essentially, five-year growth estimations for the regional countries (excluding Mongolia) are far below the previous decade averages, and slower than the estimated average growth of emerging and developing markets as a whole.

Figure 1: Average Annual Real GDP Growth Rate (%)



Source: OECD calculations based on data from IMF and EBRD.
*Based on IMF's World Economic Outlook April 2011 estimations.

19. Eurasian countries also faced hyper-inflation, especially in the first five years of their independence. The hyper-inflation problem has been reduced across the region, but still some countries Ukraine (16% in 2009), Uzbekistan (14% in 2009) and Belarus (13% in 2009) have high consumer price inflation compared to the world (2.5%) and developing economies' (5.18%) average.

3. Capital Markets Landscape in Eurasia

20. The capital markets in Eurasia have only a two-decade history. However, over the last decade along with the high performance of these economies, interest both from national and international players has grown towards these markets. Despite the level that has been achieved by these countries in 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[3]. Another index company, MCSI, has classified Kazakhstan and Ukraine as frontier markets.

21. The World Economic Forum's global competitiveness assessment model assigns scores to countries on the basis of 12 pillars, including financial market development. Azerbaijan has the best rank in the region, 57th out of 139 countries. More importantly, with the exception of Kyrgyz Republic, all Eurasian countries' financial market development rankings are lower than their own overall competitiveness ranking. In particular, their performance on sub-pillars *financing through*

[3] 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).

local equity market and *regulation of securities exchange* appear to have a negative effect on their overall competitiveness.

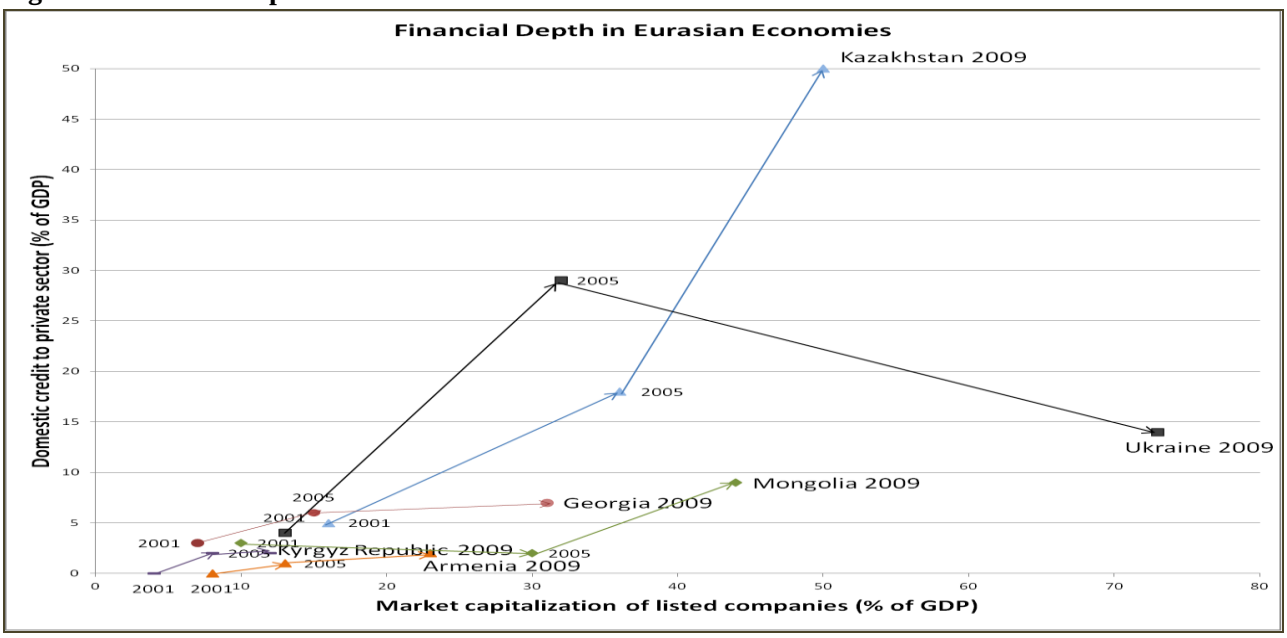
Table 1. Financial Market Competitiveness in Eurasia

Country	Overall Rank (out of 139)	Financial Market Development	Financing through local equity market	Regulation of securities exchanges
Armenia	**98**	**110**	131	121
Azerbaijan	**57**	**71**	79	103
Georgia	**93**	**108**	125	124
Kazakhstan	**72**	**117**	106	119
Kyrgyz Republic	**121**	**111**	121	132
Moldova	**94**	**103**	124	116
Mongolia	**99**	**129**	99	129
Ukraine	**89**	**119**	120	127

Source: The Global Competitiveness Report 2010-2011

22. 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 driving the region's growth, but with improvements in their functioning retain the potential to positively influence economic growth and competitiveness in the future.

Figure 2. Financial Depth in Eurasian Economies



Source: Based on data from World Bank and EBRD

23. Financial 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 financial system. Private credit and stock market capitalisation as percent of GDP are the most widely used measures used as a basis for these two indicators (ADB, 2010). As seen from 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. Only in Kazakhstan have the two parts of the financial system developed together and reached the best position around the region. In Ukraine, before the financial turbulence in 2008, both equity (78.3% of GDP) and bank credit (58.2 % of GDP) markets reached a high level.

Box 1- Financial Sector in Afghanistan

The Central Bank of Afghanistan's Strategic Plan of 2009-2014 cites total financial sector assets of about 18.3 percent of GDP and an annual growth rate of 57% as a sign of "remarkable success." According to their report, total assets of the banking system rose to AF 116.4 billion (USD 2.24 billion) at the end of the 2008, up 57 percent from the previous year. Bank deposits stood at USD 1.78 billion equivalents in December 2008, a 94 percent increase from December 2006.

The report suggests that despite its achievements, Afghanistan's financial sector has the potential to contribute more towards economic growth. Credit to the private sector stands at only 10 percent of GDP, and access to financial services, especially credit and payment, is extremely limited. The sector is dominated by three commercial banks, which hold 93 percent of system assets.

Currently, the securities market consists of central bank securities called capital notes, which are electronically traded between DAB and commercial banks.

Source: Da Afghanistan Bank - Central Bank of Afghanistan, Strategic Plan (2009-2014)

a. Equity and Bond Markets

24. 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 (42.5%) and total amount (60.7 million USD).[4] Ukraine (28.6%) and Mongolia (17.9%) also have relatively more developed stock markets.

25. 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. For example, free float for listed companies in Ukraine is estimated to be only 4% of market capitalisation (Smith, 2006).

26. The low level of liquidity in Eurasian stock markets (refer to Annex 1) is also related to the methods that have been adopted for mass privatisation transactions in the 90s. In Mongolia, the

[4] The largest stock market in the region, Kazakhstan has the 47th largest market capitalisation as percent of GDP out of 97 economies in the world, as the end of 2010 (World Bank Development Indicators).

government provided vouchers to each citizen with a right to purchase state shares in SOEs. The reorganisation and listing of these 475 SOEs were the first step for capital market development. However, the government's additional selling of remaining shares through auctions resulted in a sharp decrease in market liquidity (Tsolmon, 2008).

27. 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 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 have helped countries to initially reach a high number of listed companies in their national exchanges. However, there has been a downward trend due to delisting of many of these companies and lack of new listings.

Table 2. Market capitalisation of listed companies, 2010

	Current US$, (million)	**%GDP**
Armenia	28	0.3
Azerbaijan	114.9	0.2
Belarus	NA	NA
Georgia	1,060	9.1
Kazakhstan	60,742	42.5
Kyrgyz Rep.	79	1.7
Moldova	NA	NA
Mongolia	1,093	17.9
Ukraine	39,457	28.6
Uzbekistan	NA	NA

Source: World Bank, Azerbaijan State Committee for Securities

28. The size of corporate bond markets in Eurasian countries is even smaller than stock markets. There are active bond markets in Ukraine, Kazakhstan, Belarus, Mongolia and Azerbaijan, but most concentrate on the trading of 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.

29. 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

30. The introduction of securities regulations and 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).

31. 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 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.

32. As one of the twelve key standards designated by the Financial Stability Board for sound financial systems, the IOSCO's Objectives and Principles of Securities Regulation states that capital market regulators should be operationally independent and accountable in the exercise of their functions and powers. Moreover, the OECD Principles recommend that the regulators should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. However, the IOSCO standard 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, which can be organised either as a separate state body or under central banks or relevant ministries.

33. 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, don't have an assurance in the 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 the authorities.

34. Although a number of Eurasian regulators are regular members of IOSCO[5], none of them have signed IOSCO's *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.

35. Adopting the key standards designated by FSB, in particular OECD's Corporate Governance Principles and IFRS, together with the IOSCO principles and the IOSCO MMoU, would support

[5] 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.

compliance of the national securities market frameworks to international standards and increase their credibility among international investors, helping these economies to access international capital markets. In most Eurasian countries, corporate governance codes for listed companies based on the OECD Principles have been issued, but generally they are voluntary-based and in some cases would benefit from significant revision[6]. The IFRS' requirement of full compliance with the standards to describe a financial statement as an IFRS financial statement makes assessment of countries' compliance level easier. The IFRS as published by the IASB is required for listed companies in most Eurasian countries. However, in other countries, local translations of old versions of the IFRS are accepted, or the IFRS is not required but permitted to be used (PWC, 2011)[7]. While the broad adoption of IFRS would provide an important indicator of international convergence status, the quality of how these standards are implemented in practice will also be critical. This will also depend upon capital market authorities' enforcement capacities and the quality of independent audit.

c. Stock Exchanges in Eurasia

36. 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.

37. Since 1993 when the first demutualisation of an exchange occurred in Sweden, there has been an ongoing 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).

38. 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 3 below for details).

39. 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.

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[6] In Mongolia a separate code for banks was published in 2003 and a code for SOEs is currently under development. In Georgia the code is only for banks. (IFC, 2011)

[7] IFRS is required in Armenia, Azerbaijan, Kazakhstan, Kyrgyz Republic, Mongolia; permitted in Afghanistan and Uzbekistan; local translation is in use in Georgia, 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.

Table 3. Stock Exchange Landscape in Eurasia

Country	Stock Exchange	Establishment	Ownership Structure	Number of Listed Companies (End of 2010)	Trade Volume (Stock, million USD)
Armenia	Nasdaq OMX	2000	Privately-held	11	0.35
Azerbaijan	Baku Stock Exchange	2000	Privately-held	2[1]	551.5
Belarus	Belarusian Currency and Stock Exchange	1998	State-Owned Company	1901	92.9
Georgia	Georgian Stock Exchange	2000	Privately-held	138	2.9
Kazakhstan	Kazakhstan Stock Exchange	1993	Privately-held[2]	118	1,899.6
Kyrgyz Rep.	Kyrgyz Stock Exchange	1994	Privately-held	24	9.1
Moldova	Moldovan Stock Exchange	1994	Privately-held	1020	21.7
Mongolia	Mongolian Stock Exchange	1991	State-Owned Company	336	48.6
Ukraine	PFTS Stock Exchange	1997	Privately-held	302	n.a
	Ukrainian Exchange	2008	Privately-held	n.a	n.a
	Ukrainian Stock Exchange	1991	Not-for-Profit Company	37	0.6
	Perspectiva Stock Exchange	2006	Privately-held	n.a	n.a
Uzbekistan	Tashkent Republican Stock Exchange	1994	Public Institution[3]	68	38.8

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 Center of Almaty JSC is the largest shareholder without majority.

3 Public institutions describe non-commercialised state-owned exchange that organised as a state agency.

40. 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[8], 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 Stock Exchange, is a not-for profit company. The other two important exchanges, Perspectiva 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

[8] The largest stock exchange of Russian Federation, the MICEX acquired the 50%+1 share of the PFTS in 2010. Currently MICEX and the second largest stock exchange of the Russian Federation, the RTS are in the process of a merger which is expected to be finalised at the end of the 2011.

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).

41. Finally, due to the low level of capital market development and desire to develop national 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 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 majority shares of 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, 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.

42. 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[9]. 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. Along with market infrastructure problems, existing investment restrictions on foreign investors in some cases also limit the participation of foreign institutional investors in these markets.

Box 2. Public Disclosure Platforms in the Region

Ukraine - With several market places for securities, a central public disclosure system for use by investors in stocks and corporate bonds is particularly important. The Ukrainian securities regulator, the SSMSC, has developed the Electronic System for Comprehensive Information Disclosure (ESCRIN) as a web-based electronic disclosure platform. All Ukrainian listed companies and issuers of corporate bonds are required to disclose their ad hoc information, quarterly and annual reports via the system from the beginning of 2011. It is a free of charge service provided by the Ukrainian government.

d. Privatisation and Capital Markets

43. Raising funds and increasing the economic efficiency of national companies have been considered the main objectives of governments for privatisation. Development of national stock markets through public offerings of these companies has also been a significant factor influencing privatisation initiatives (Meggission and Boutchkova, 2000). Indeed, widespread privatisation transactions during the mid-1990s through stock markets provided the initial steps toward capital market development in the region. However, due to the substantial remaining presence of state-owned large JSCs and inadequate attention to how the privatisation programmes were designed as catalysts for the development of stock markets, these transactions have not made a significant contribution to capital market development, especially in Central Asian economies (Conrad, 2008).

[9] 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.

44. During the last decade, USD 11.7 billion worth of privatisation transactions in the region have not had significant effects on stock market development. Only one privatisation transaction, KazMunaiGas of Kazakhstan, was conducted through an IPO, and it is listed both on the London Stock Exchange and Kazakhstan Stock Exchange. Including KazMunaiGaz, 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 private ownership rather than any kind of dispersed share ownership within local capital markets.

Table 4. Privatisation Transactions in Eurasia Region, 2000-2008 (Million, USD)

Afghanistan	80
Armenia	196
Azerbaijan	191
Belarus	328
Georgia	1,822
Kazakhstan	3,039
Kyrgyz Republic	2
Moldova	46
Tajikistan	1
Ukraine	5,924
Uzbekistan	71
Total	**11,700**

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

45. 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 5. Ten Largest Privatisation Transactions in Eurasia Region (2000-2008)

Country	Year	Sector	Name	Amount in US$ (in millions)
Ukraine	2005	Competitive	Kryvorizhstal	4,800
Kazakhstan	2006	Energy	KazMunaiGas	2,300
Belarus	2008	Infrastructure	BeST	300
Kazakhstan	2000	Infrastructure	Ekibastuz Power Station 2	300
Georgia	2007	Financial	Building-constructions, Tbilisi	182
Azerbaijan	2008	Infrastructure	Azercell Telecom BV	180
Kazakhstan	2003	Energy	SNPS-Aktobemunaigaz	150
Georgia	2008	Infrastructure	Poti Sea Port Development	145
Ukraine	2004	Primary	Krasnodonvugillia	145
Ukraine	2004	Primary	Krasnodonvugillya	145

Source: World Bank Privatisation Database

4. Concluding Remarks and Issues for Discussion

46. The development level of capital markets varies from one country to another after two decades of reform endeavours in the region. All capital markets in the region are still at an early stage of development, but differ from each other in terms of market size, market participants and institutional and regulatory frameworks. Today, while in some countries there are no organised stock markets, others have exchange or trade platforms with trade volumes ranging from USD 0.35 million to USD 1.9 billion. In addition, some 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.

47. Despite these differences, all countries in Eurasia were able to achieve a high economic performance in the last decade. Strong infrastructure and vast natural resources have helped them to benefit from the advantages of late development. Most countries have used this opportunity to build their financial markets in accordance with the latest developments, unlike a number of other developing countries that have been facing difficulties in transforming their structural and regulatory frameworks because they have reflected a more deeply embedded history. However, further efforts are required to sustain this ten-year growth period.

48. 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.

49. Being aware of this relationship, this paper was prepared in order to provide background information to the first meeting of *the Group*, and to serve as a basis of a "final" report to be considered at the *Group's* second meeting in 2012. On the other hand, due to lack of comprehensive and comparable data and information on Eurasian countries, more information is needed to fully understand the situation and priorities in the region and to be able to provide a sound basis for the consideration of recommendations. Therefore, it is proposed to send a questionnaire to all countries after the first meeting. The final report will consider responses to the questionnaire and discussions of the Group. Potentially, the following topics could be covered by the report:

50. Role of capital markets in developing economies: The last global financial crisis has accelerated the discussions on the role of capital markets in national economies. In particular, developing countries' financial markets have drawn attention to their performance during the crisis. Today, development of the financial sector is accepted to be one of the main drivers of economic growth. The link between capital market development and economic growth with a special emphasis on the Eurasian economies could be addressed.

51. Market size and structure in the Eurasian countries: Updated comparative data on equity and corporate bond markets including market capitalisation, trade volumes, free float ratios and listed companies could be presented.

52. Regulatory and supervisory structure: Capital market authorities and regulations on securities markets were introduced in the mid-1990s shortly after Eurasian countries' independence. In recent years, there have been significant developments in capital market regulatory environments, such as consolidations under central banks. Effectiveness of different models of regulatory frameworks, addressing institutional arrangements providing for a separate state body or having functions carried out within central banks or under relevant ministries, will be discussed with regard to both the OECD and IOSCO's Principles relating to capital market regulators' operational independence and accountability in the exercise of their functions and powers. Furthermore, challenges and priorities to strengthen regulatory capacity to develop sound corporate governance frameworks and more active capital markets in the region could be addressed.

53. Stock exchanges landscape: An overview of the stock exchange industry of the region, their regulatory powers and relationship with capital market regulatory authorities could be provided. Many stock exchanges in the region have been established as private companies with regulatory powers. However, recent years have seen some examples of internationalisation and consolidation of exchanges. The effect of this trend, effectiveness of internationalisation and consolidation and regional cooperation possibilities could also be addressed. Furthermore, exchanges play an important role in developing and implementing corporate governance codes and ensuring transparency of markets. New instruments of exchanges for promoting corporate governance, such as different tiers and corporate governance indices, also raise questions regarding their relevance for Eurasian exchanges.

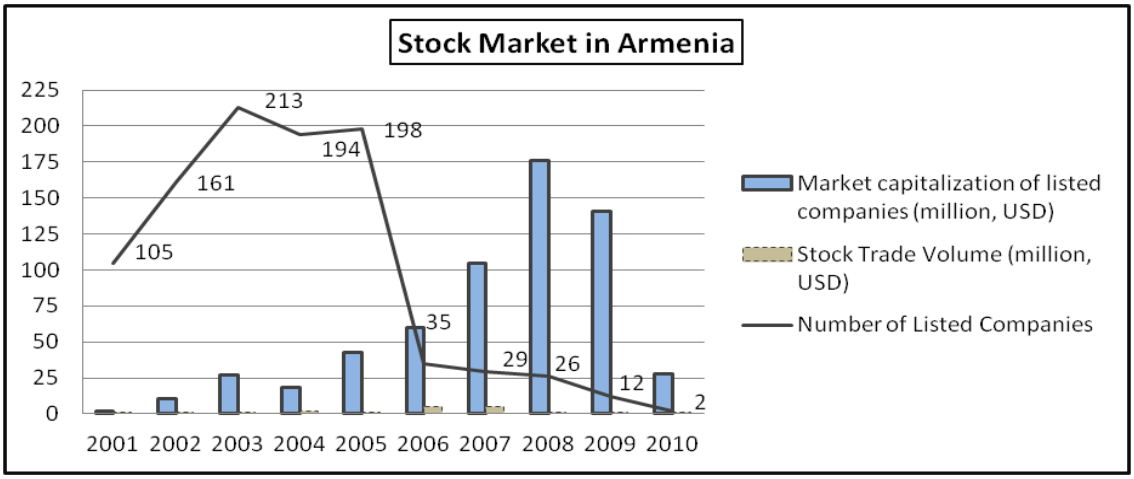
54. Institutional investors: Institutional investors such as insurance companies, pension and investment funds are significant players in global financial markets, with an increasing share of investment in capital markets. To date, except in very limited cases, they haven't contributed much to capital market development in the region. Moreover, their role in promoting corporate governance has also received considerable attention. This section will discuss how to improve institutional investors' participation in the Eurasian markets and to what extent regional economies benefit from other developing countries' experiences.

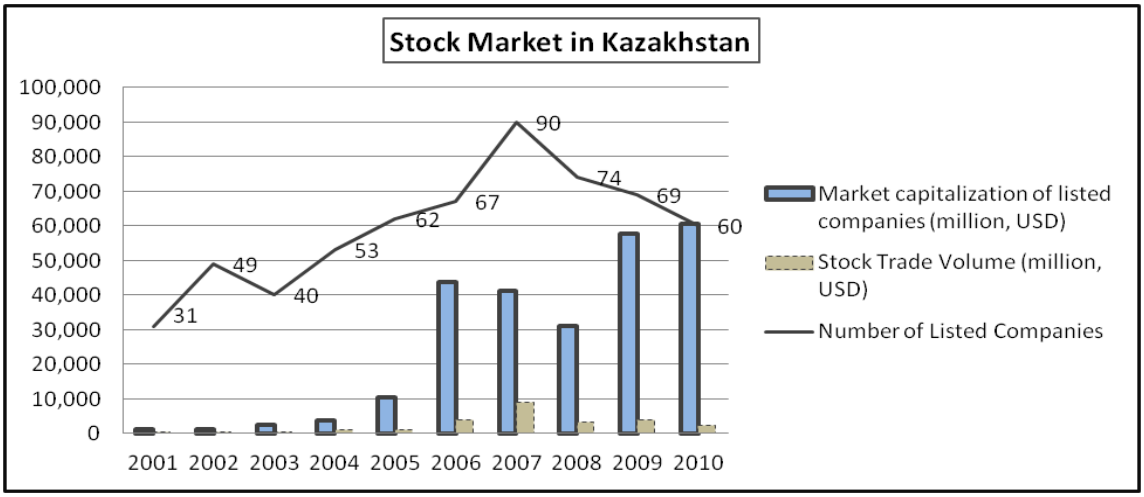
55. State ownership and capital markets: Mass privatisation transactions during the mid-1990s through stock markets didn't contribute significantly to capital market development in the region. Partial privatisation of some blue chip SOEs through IPOs are currently on the agenda of some Eurasian countries. This raises questions concerning how these transactions could help capital market development, and what lessons have been learned from previous mass privatisation processes. Moreover, the question of how governance arrangements in place for state ownership may influence the willingness of private investors to share ownership with the state through IPO arrangments is worth considering in the context of Kazakhstan's and other countries' recent initiatives in this domain. The transparency and disclosure framework for listed SOEs and their compliance with this framework is also relevant to the question of state ownership and capital market development.

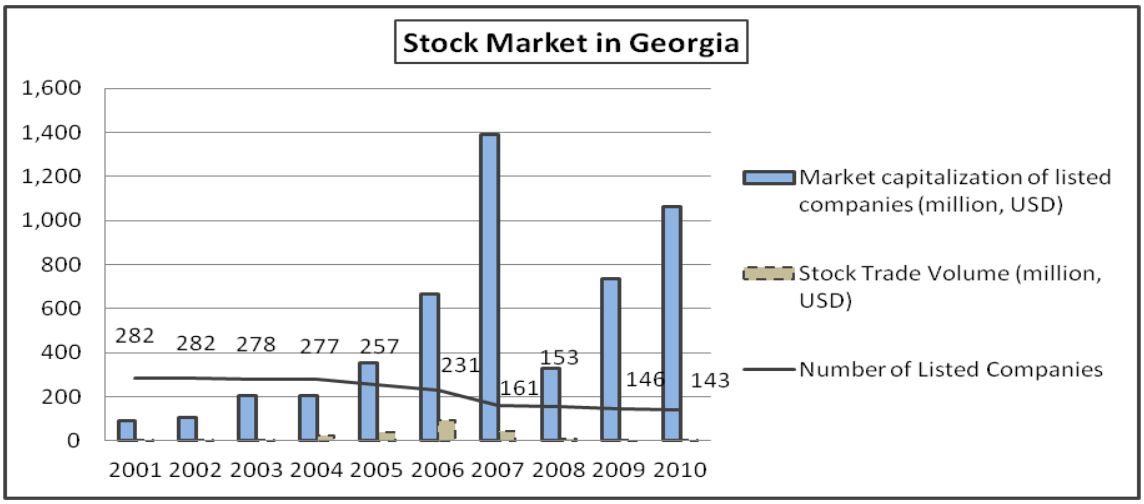
56. Building investor confidence and corporate governance priorities for capital market development: It is widely accepted that effective corporate governance frameworks promote investor confidence in capital markets, and help companies to lower capital costs and attract foreign capital. Taking into consideration the main features of the corporate governance framework and capital markets of the Eurasia region, policy recommendations could be developed and considered to support

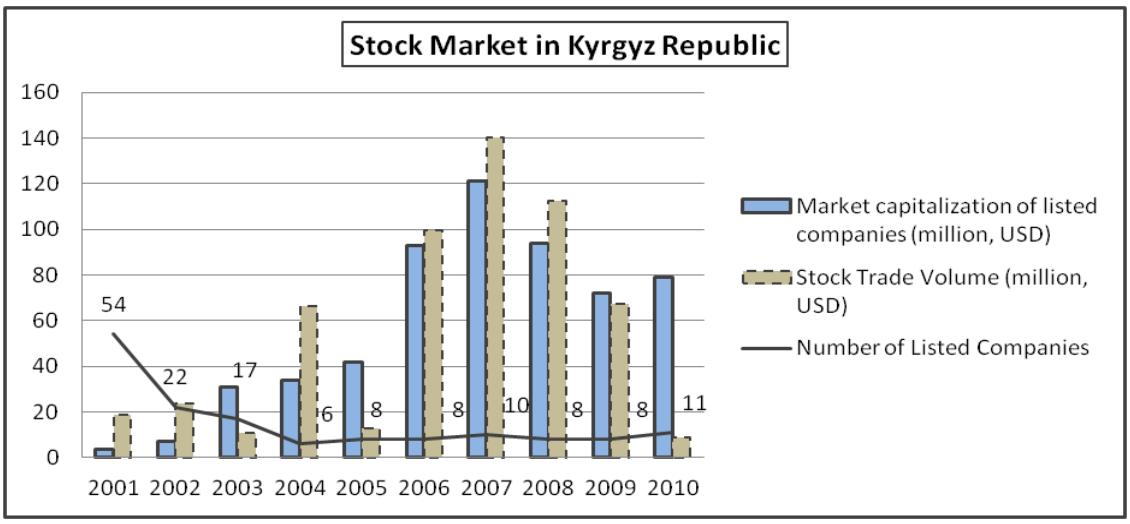
corporate governance for capital market development. In this context, the framework for securing shareholder rights and equitable treatment and disclosure could be a first priority. Building a credible regulator and effective enforcement systems along with legislative efforts are crucial elements for securing shareholder rights and equitable treatment. The quality of public disclosure is also an important element, requiring convergence with international standards and best practices for a better disclosure framework.

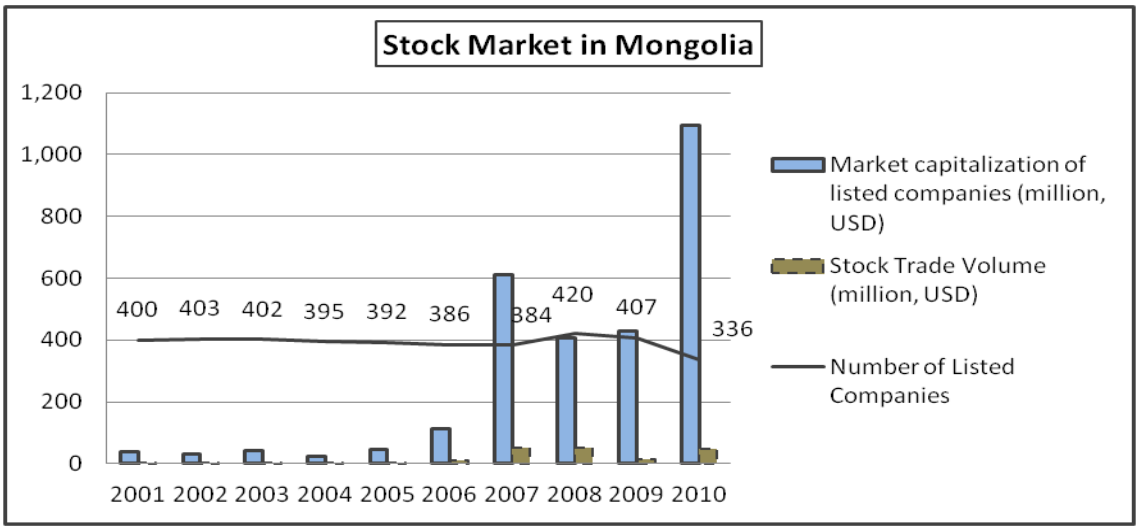
Annex 1- Stock Markets in Eurasia

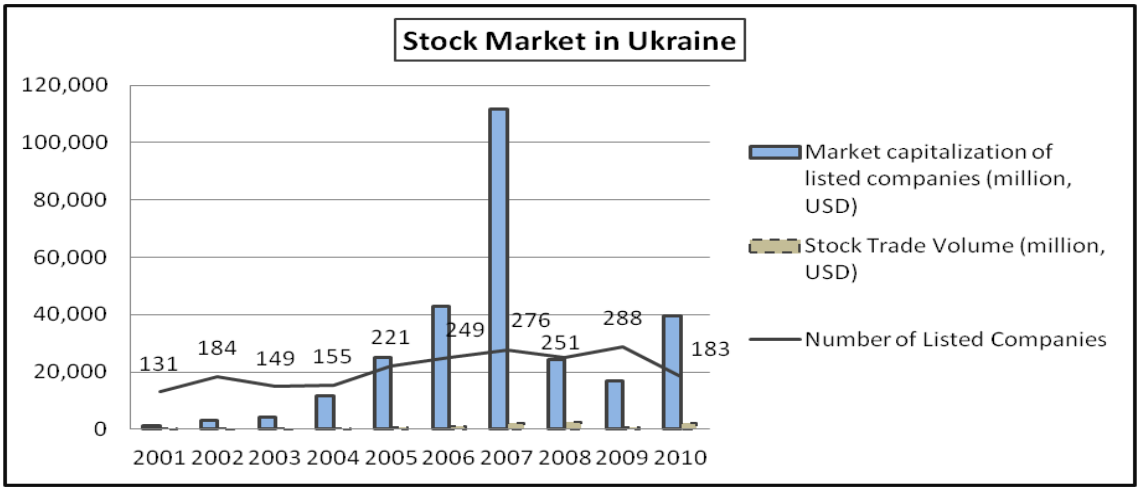


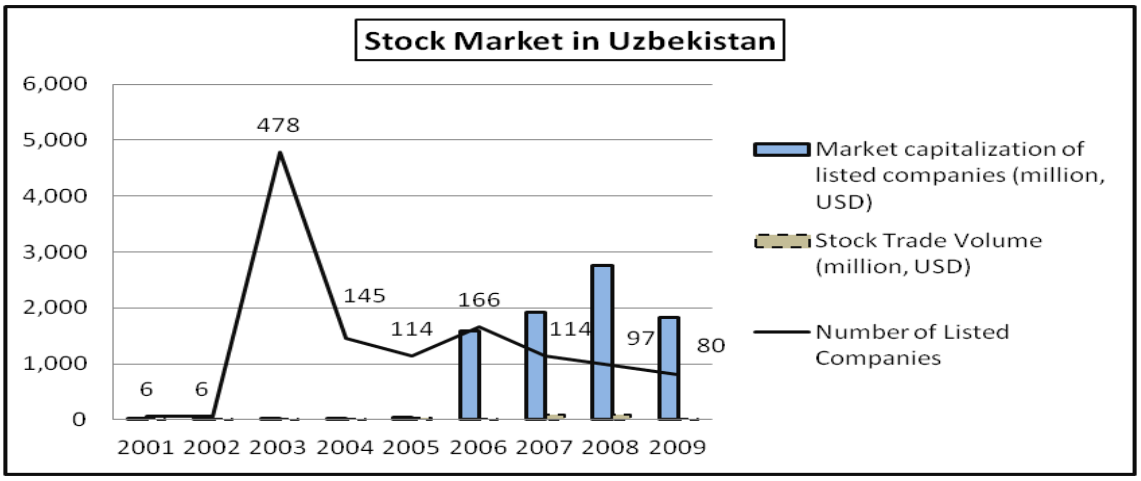





Stock Market in Kyrgyz Republic
160
140
120
100
80
60
40
20
0
54
22
17
6
8
8
10
8
8
11
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Market capitalization of listed companies (million, USD)
Stock Trade Volume (million, USD)
Number of Listed Companies


Stock Market in Mongolia
1,200
1,000
800
600
400
200
0
400 403 402 395 392 386 384 420 407 336
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Market capitalization of listed companies (million, USD)
Stock Trade Volume (million, USD)
Number of Listed Companies


Stock Market in Ukraine
120,000
100,000
80,000
60,000
40,000
20,000
0
131 184 149 155 221 249 276 251 288 183
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Market capitalization of listed companies (million, USD)
Stock Trade Volume (million, USD)
Number of Listed Companies



Source: Based on data from World Bank, FEAS and national stock exchanges.

Annex 2: Stock Exchanges' Infrastructure in Eurasia

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

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