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Keeping up with the Kazakhs – an update on recent regulatory changes and recommendations for further reforms

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This article examines recently adopted and proposed regulatory and legislative changes related to the development of local equity and debt capital markets in Kazakhstan and makes recommendations for future reforms.



Introduction

The difficulties the banking sector in Kazakhstan is experiencing, and the fact that international financial markets have been closed for most Kazakh companies for some time, can in fact be seen as a blessing in disguise for the development of Kazakhstan's local capital markets. With cheap bank credit cut off and opportunities to list abroad out of reach, Kazakh companies have started to consider using the local capital market to raise money instead. The development of a local capital market has become one of the priorities of the government of the Republic of Kazakhstan, who fully appreciated the risks related to the over-dependence on foreign markets, borrowing in foreign currency and the importance of stable, local sources of funding. One of the latest ambitions of the Kazakh government is a massive

privatisation programme of Kazakh blue-chip companies, the so-called "People's IPO".

This article will first examine the changes that have been recently adopted and second, critically review the reforms which are now being proposed.

Effective regulatory and legislative changes

Financial mega regulator

To begin with it is worth mentioning that in 2011 Kazakhstan consolidated its financial and securities regulators under the auspices of the National Bank. According to the President of Kazakhstan's decree of 12 April 2011, the Agency on Regulation and Supervision of the Financial Market and Financial Organisations (the FMSA) and the Agency on Regulation of Activities of the Regional Financial Centre of



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Almaty were abolished and their functions transferred to the National Bank.

Defaulted bonds restructuring

There have been a number of laws and regulations adopted as a direct reaction to the financial crisis of 2008, in particular to address the issue of the increased number of defaulted bonds listed on the Kazakhstan Stock Exchange (KASE). In 2009 the FMSA reduced the capitalisation requirements of KASE-listed issuers of debt securities without rating. This measure gave an opportunity to the issuers to use funds for the repayment of debt rather than keep them for meeting the tough capital requirements of the regulator. Another measure was the introduction by the FMSA of the so-called “buffer category” to the official list of KASE. Securities whose issuer has:

- (i) ceased to comply with KASE requirements
- (ii) defaulted on its obligation to pay interest (except interest payment on the last coupon) or
- (iii) started restructuring of its obligations, may, if approved by KASE, be included in this buffer category for a maximum period of 12 months.

Should the financial position of the defaulted issuer improve during this 12-month period, the securities of the issuer may be transferred back to the relevant listing category of the KASE official list where they were listed before. Moving securities into the buffer category has two main goals:

- (i) it gives the defaulted issuer 12 months to improve its financial position without its securities being delisted
- (ii) it allows bondholders to keep abreast of the ongoing performance of the defaulted issuer.

In addition the 2011 Law on Investors Protection¹ introduced the possibility to restructure corporate bond debt on securing a minimum of 85 per cent of bondholders' votes at the general meeting. However, it seems that even on approval of the proposed restructuring by more than 85 per cent of the bondholders, a dissenting creditor may still have a legal right to file for bankruptcy. Such a

regime is different from the judicial restructuring framework available for financial institutions where, on approval of the restructuring by more than two or three creditors, the bank would benefit from a judicial shield against any claim of dissenting creditors. It is not clear why commercial entities cannot benefit from a similar legal framework which market participants have been demanding for some time now.

Corporate governance

Corporate governance is another important issue for the development of the securities market in Kazakhstan and the Law on Investors Protection contains a number of provisions in this respect. First, the personal liability of the management of a joint stock company (JSC) for actions and/or inactions which have caused losses to the JSC as a result of those actions and/or inactions, has been introduced. Second, shareholders are now entitled to file an action for compensation from the management of the JSC in relation to so-called major transactions and (or) interested party transactions. Interestingly, although this measure has been aimed to encourage management to perform their duties and take corporate decisions thoroughly, it seems that in practice the result has been to discourage good candidates to act as independent directors of Kazakh companies and, reportedly, members of management bodies of JSCs are now reluctant to take any significant risk or take important decisions for the company.

Lastly, the Law on Investors Protection has also introduced a mandatory requirement for the JSC to make prior evaluation of the market value of any property the JSC intends to acquire or sell, if the property value is estimated to be 10 per cent or more of the JSC's total assets.

Pension regulation

From 1 January 2012 a Kazakh pension fund will have to offer its participants two types of investment portfolio. A “conservative” portfolio and a “moderate” portfolio and, at some point in the future, it is envisaged that the fund would be able (but not obliged) to offer a so-called “aggressive” investment portfolio. The main idea behind such change is that assets in the conservative portfolio would only be invested in the most reliable financial instruments (for example, cannot be invested into equity securities). Such a portfolio would be particularly suited to people who are close to retirement age. Assets of the moderate portfolio would



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be invested in a broader range of financial instruments (including up to 30 per cent in equity securities), which are more risky but also potentially carry a higher-yield. As for the aggressive portfolio, this would be a good option primarily for young citizens who are able to take higher risk (limitation on equity investment of up to 80 per cent will be applicable). Importantly, the state guarantee which is currently provided for all pensions would only cover conservative and moderate investment portfolios and not aggressive portfolios.

Overall, we believe that the proposed changes in pension regulation will have a positive effect on the development of a capital market in Kazakhstan, as pension funds are the largest group of investors in Kazakhstan and the reform will enable them to invest part of their assets in more risky securities to increase their profitability. Currently the investment activity of pension funds is limited to high-quality but low return financial instruments (such as state bonds) that barely cover inflation.

Islamic bonds

To diversify sources of financing and alleviate the dependence of Kazakhstan from external funding from Western capital markets, the Kazakh government has pursued the development of Islamic finance and certain legislative amendments² were adopted in 2011 that now allow a much broader range of Kazakh companies to issue sukuk (Islamic bonds).³ Although no issuance of sukuk has yet happened, putting relevant legislation in place creates the possibility for corporate issuers to use this new tool for raising capital.

Expected regulatory and legislative changes

Significant changes in the Kazakh capital markets legal framework⁴ are expected in the near future with the very recent adoption of the Law on Minimisation of Risks, which was signed by the President of Kazakhstan on 28 December 2011 and should take legal effect in the first half of 2012.⁵ The most important changes are presented here.

Ownership structure of pension funds

Specific conditions would become applicable to the ownership structure of Kazakh pension funds⁶ as of 1 January 2013:

- (i) all shares shall be listed on KASE and can also be listed offshore, subject to the approval of the National Bank
- (ii) A pension fund shall have at least three so-called “large shareholders” (that is, who have 10 per cent and more shares each) and who are not affiliated with each other. A single shareholder or group of affiliated shareholders shall have not more than 75 per cent voting shares of a pension fund. Alternatively, the total stake of minority shareholders in a pension fund shall exceed 25 per cent of voting shares.

It seems that the government of Kazakhstan considers an IPO to be an effective means of diversification of shareholding of pension funds and that it can positively affect development of equity capital markets in Kazakhstan.

Approval for listing of securities abroad and placement abroad

A new provision of the Law on Minimisation of Risks requires that a “resident”⁷ of Kazakhstan receives prior approval from the National Bank for the “listing” of securities on a foreign stock exchange.

The current Kazakhstan law already required that any placement abroad of securities by an issuer who is a “resident” of Kazakhstan shall be subject to, *inter alia*, prior listing of the issued securities on KASE. The Law on Minimisation of Risks has now clarified that if

- (i) the issuer is a foreign legal entity
- (ii) whose *de facto* place of effective management is in Kazakhstan
- (iii) 50 per cent or more of its shares/participatory interests belong to a Kazakh (parent) company, the abovementioned statutory requirement of prior listing of securities on KASE shall be applicable not to the foreign issuer itself, but to its Kazakh parent company. In other words, if a Kazakh company establishes an offshore special purpose vehicle (SPV) for an initial public offering (IPO) on a foreign stock market, the securities of such Kazakh company (and not that of the SPV) must now be listed on KASE as a condition precedent to IPO of the SPV.



The Law on Minimisation of Risks has also substantially expanded the list of people considered “insiders” for the purpose of the Securities Law

The underlying intention of the financial regulator for making the process of listing and placing abroad more regulated appears to make raising capital domestically more attractive.

Local offer requirement

The Law on Minimisation of Risk goes even further in that it compels Kazakh resident issuers not only to just *offer* bonds on the local stock exchange simultaneously with a placement on the foreign stock exchange, but to actually *sell* at least 20 per cent of the total issuance *if there is demand*. Perhaps it is also part of the overall trend of protecting the Kazakh domestic capital market by limiting competition with international capital markets.⁸ In the past, Kazakh issuers had circumvented the rules by simply offering securities on KASE without having any actual intention to sell them in Kazakhstan.

Thus we expect that fewer Kazakh companies will be eager to run an IPO or issue eurobonds in foreign markets such as London and may now prefer to raise finance (at least partially) in Kazakhstan.

Insider trading

The Law on Minimisation of Risks has also substantially expanded the list of persons that shall be considered “insiders” for the purposes of the Securities Law. Auditors, brokers, independent appraisers, stock exchange staff, state officials of the National Bank and any other persons who have access to insider information could now be considered as “insiders”. The legislator has also clarified which transactions would entail administrative liability for insider trading:

- (i) an “insider” would now be administratively liable not only for *transfer* of insider information to a third party or for *providing recommendations* to third parties based on insider information as under current Kazakhstan law, but also for *usage* of insider information while making transactions with securities and/or derivatives by the insider himself
- (ii) officials of the Kazakh company (that is the issuer of securities) may be held administratively liable for failing to meet statutory requirements of due control over usage and transfer of insider information about the company or its securities.

Insider trading is a real problem in Kazakhstan that undermines the trust of investors and professional participants of the securities market. While there is no court practice in Kazakhstan on insider trading at the moment, improvement of the insider trading framework is to be welcomed.

Representative of bondholders

The Law on Minimisation of Risks provides that interests of any bondholders before the issuer shall be represented by a special organisation (that is, representative of bondholders) which has previously been available only for the bondholders of infrastructure bonds and secured bonds. In addition, statutory powers of the representative have been broadened. These would better protect interests of the bondholders.

Mandatory covenants of bonds issuer

From now on, all Kazakh companies⁹ will have to undertake and comply with (until the bonds' expiration date) certain mandatory negative covenants to be able to issue local bonds:

- (i) the issuer cannot sell more than 25 per cent of its assets
- (ii) the issuer shall not be in default under any of its obligations other than bonds for the amount of more than 10 per cent of its total assets as of the date of state registration of the bonds issuance
- (iii) the issuer cannot make changes in its constituting documents which would provide for a change in the core business of the company
- (iv) the issuer cannot change its form of incorporation.

These prohibitions are evidently aimed at protecting the interests of the bondholders. Should the issuer breach any of the above covenants, bondholders are entitled to require the issuer to buy back the bonds at par value with accrued interest.

Central counterparty

The Law on Minimisation of Risks has also introduced a central counterparty (the “CCP”) concept. It is assumed that CCP will lower the market-side risks and the

Notes and authors

costs of post-trade processing, for example, as part of the introduction of the T+3 settlement by KASE. We note, however, that, whereas CCP implementation normally requires the establishment of a special reserve and guarantee funds, the proposed legislative changes are silent on this matter.

“People's IPO”

Apart from the Law on Minimisation of Risks discussed above, a Law “On People's IPO” has been prepared for the purpose of the privatisation of a number of blue chip companies and is now under consideration by the senate of Kazakhstan.¹⁰ Once adopted, the Law would allow an IPO's first three candidates¹¹ to be done on KASE. The main provisions of the draft IPO Law concern:

- (i) the removal of the obstacles for proposed IPOs (for example, KEGOC cannot be privatised because of statutory restriction)
- (ii) the improvement of the legal framework related to disclosure of information to investors
- (iii) the strengthening of the protection of investors' rights and interests
- (iv) the improvement of infrastructure of the securities market.

The main target investors of the proposed offerings under the People's IPO programme are the citizens of Kazakhstan and pension funds.

Conclusion and recommendations

There is fierce competition between different capital markets in the world for issuers and liquidity. The only chance for Kazakhstan to develop its own capital market and become the financial centre of central Asia is, as a minimum, to put in place a friendly legal framework for investors and issuers and to create the appropriate infrastructure.

This has indeed been the concern of the financial regulator and the government of Kazakhstan and more reforms are expected under the framework of a state programme called “Road Map of Development of Pension Saving System and Securities Market of the Republic of Kazakhstan”, as approved by the government of Kazakhstan.

We would generally recommend an approach that concentrates on motivating market participants to raise finance locally (for example, providing a tax exemption for a company whose shares are listed and traded on KASE), rather than on making this process abroad more bureaucratic and complicated. Experience shows that a balance between the “carrot and the stick” approach is always preferable.

¹ Law of the Republic of Kazakhstan 406-IV 3PK dated 10 February 2011 “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Questions of Mortgage Crediting and Protection of Rights of Financial Services Consumers and Investors” (the “Law on Investors Protection”).

² Law of the Republic of Kazakhstan N475-IV 3PK dated 22 July 2011 “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Questions of Arranging Islamic Finance”.

³ Prior to the reform, only very limited legal entities were allowed to issue sukuk (e.g. NWF Samruk-Kazyna JSC's Group entity).

⁴ We must note, however, that the primary purpose of the proposed legislative changes is the introduction of stringent rules governing relations between a Kazakh bank and its affiliates and cutting off banks from expressly or impliedly affiliated structures. This seems to be a reaction of the financial regulator to BTA Bank case (BTA, before it was bailed out by the Government of Kazakhstan in 2009, made many loans to its affiliates and now it is practically impossible for BTA to get its money back).

⁵ Draft Law of the Republic of Kazakhstan “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Questions of Regulation of Banking Activity and Financial Organisation in the Part of Minimisation of Risks” (the “Law on Minimisation of Risks”). For the purposes of this article, we only analysed the draft as submitted to the Senate of Kazakhstan.

⁶ These legal requirements would not be applicable to pension funds if one of its shareholders is the Republic of Kazakhstan.

⁷ For the purposes of the Law of the Republic of Kazakhstan “On Securities Market” № 461-II dated 2 July 2003 (the “Securities Law”), residents of Kazakhstan shall be considered companies incorporated outside of Kazakhstan if their place of management is *de facto* in Kazakhstan or if two-thirds of their assets are located in the territory of Kazakhstan.

⁸ Due to some inconsistency between the Securities Law as amended by the Law on Minimisation of Risks and the KASE Listing Rules as amended on 21 September 2011 there is some uncertainty as to whether the new rules will apply to both debt and equity securities, on placement in foreign securities markets.

⁹ These statutory restrictions are not applicable to banks and organisations under restructuring as provided in relevant laws.

¹⁰ Draft Law of the Republic of Kazakhstan “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan with regards to Development of the Capital Market in the Republic of Kazakhstan” (the “Draft IPO Law”). These companies are members of the NWF “Samruk-Kazyna” JSC's group.

¹¹ KazTransOil JSC, KEGOC JSC and AirAstana JSC.



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