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STOCK EXCHANGE DEVELOPMENT
AND NEW ISSUANCE SUPPORT
FOR THE REPUBLIC OF KAZAKHSTAN

Initial Diagnostic Review

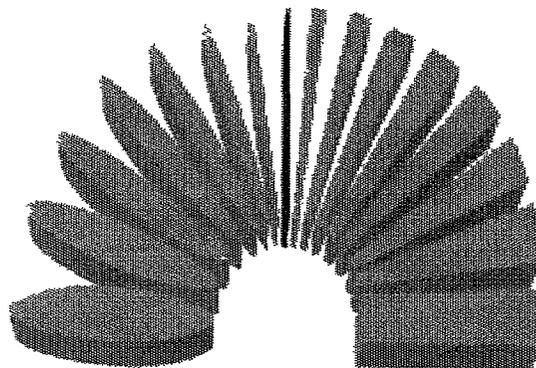
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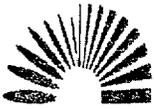
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SUBJECT	Pages
INTRODUCTION	
Background and Objectives	1
Approach	1
SECTION I REGULATORY FRAMEWORK, SELECTION OF STOCK EXCHANGE, AND NEW ISSUANCE SUPPORT	
Regulatory Framework and Selection of Exchange	3-8
- Existing Exchanges	
- Current Operation	
- Existing Legal Framework	
- Constraints	
- Recommendations	
New Issuance Support	8-14
- Objectives and Considerations	
- Identification of Potential Underwriters	
- Selection of an IPO Candidate	
- Recommendations	
SECTION II SECURITIES MARKET SYSTEMS	
Existing Institutions	15-17
- GKI Information Centre	
- Almaty Stock Exchange	
- Kazakhstan Stock Exchange	
Proposed Institutions	17
Characteristics of the Market	19
- Present Market	
- Proposed Market	
Requirements for Automation	19-23
PRELIMINARY WORKPLANS	
Regulatory Framework Selection of Stock Exchange, and New Issuance Support	24-26
Securities Market Systems	27
APPENDICES	
Appendix A List of Persons Interviewed	
Appendix B Members of the Almaty Stock Exchange	



STOCK EXCHANGE DEVELOPMENT AND NEW ISSUANCE SUPPORT FOR THE REPUBLIC OF KAZAKHSTAN

Initial Diagnostic Review

BACKGROUND AND OBJECTIVES

The Intradoss/International Management Group was engaged by USAID to implement a project to facilitate the development of a securities market in Kazakhstan. This initiative includes two components: a) the development of a modern stock exchange that can play an active role in the privatization of former state enterprises by allocating assets on the basis of economic efficiency, and b) a new issuance support program to facilitate the process of capital allocation through the stock exchange.

The objectives of the diagnostic phase of this project were as follows:

- to review and analyze current capital market trends and practices in Kazakhstan,
- to identify critical constraints that inhibit rapid capital market development,
- to develop, in cooperation with the Kazakhstan Government (GK) and consultants implementing other capital market initiatives, a view of the likely scenarios for the development of the stock exchange, and
- to develop a detailed work plan for the pilot stock exchange development phase.

The consultants were also requested to identify potential candidates for the stock exchange development project and the new issuance program.

APPROACH

The diagnostic phase of this project began on July 11, 1994. It was conducted by Intradoss Group long-term consultants, Babak Movahedi (legal specialist and team leader) and Christopher Mayzner (IPO specialist), and Deloitte & Touche long-term consultant, Valery Zaichenko, (securities market systems specialist). In addition, a preliminary analysis of the regulatory aspects of the market was conducted by short-term consultants Robert Bishop (retired Senior Vice President and Chief Regulatory Officer, New York Stock Exchange) and Vincent Plaza (retired Vice President, New York Stock Exchange).

The Intradoss team met with key individuals at all major entities involved in stock exchange development and regulation in Kazakhstan, including:

State Committee for State Property (GKI)	Ministry of Finance
Almaty Stock Exchange	Kazakhstan Stock Exchange
GKI Information Centre	



The team also met with directors of four prominent investment privatization funds, including

Alemsystems

Butya Capital

Alatau Invest

Rambek

A list of the individuals with whom the consultants met during the diagnostic phase is included as Appendix A of this report

The detailed discussion of the team's findings and recommendations which follows is presented in two sections. Section I addresses issues pertaining to the regulatory framework, selection of a stock exchange, and new issuance support. Section II addresses issues pertaining to securities market systems for the stock exchange. These reports are followed by preliminary workplans illustrating the proposed implementation of the institutional development stage.



SECTION I REGULATORY FRAMEWORK, SELECTION OF STOCK EXCHANGE, AND NEW ISSUANCE SUPPORT

REGULATORY FRAMEWORK AND SELECTION OF EXCHANGE

Existing Exchanges

There are currently two exchanges in Kazakhstan the Almaty Stock Exchange (ASE) and the Kazakhstan Stock Exchange (KSE), both of which were founded in 1991 While the goal at the time was to create a single exchange, conflicts arose and two were created Of the two, only the ASE has registered with the Ministry of Finance and has a basic operational foundation, though to date there have been no equity securities traded on either exchange

The Intrados consultants met with two key individuals at the ASE its President, Bakht Nurembetov, and Kanet Meyrmanov, its first Vice President Both were more than cooperative in providing information for this report

Currently, the ASE has 54 members, of which 40 are banks (A list of the members of the ASE is enclosed as Appendix B) There was some activity on the exchange in 1993 related to the issuance of municipal securities Presently, the ASE is helping companies register with the Ministry of Finance in anticipation of a functioning securities market

The KSE, which was founded by commercial firms, has never registered with the Ministry of Finance and has never traded any form of securities Its chief asset is its president, who has very strong political ties As of the time of this report, the consultants had not received KSE's response to a questionnaire regarding their policies and procedures and other key functions, this response is expected shortly However, the consultants met several times with the KSE's Vice President, Erken Bektaev, who also has strong connections with the President of Kazakhstan and who provided background information on the history of the KSE

Current Operation

As previously mentioned, there is currently no trading activity on either exchange, as Kazakhstan lacks a secondary market Consequently, the country has two ineffective stock exchanges in an economy that cannot presently support a single exchange This issue will be addressed in more detail in our recommendations for the implementation phase of this project

Existing Legal Framework

Background

Kazakhstan became independent on December 16, 1990, and its constitution was adopted on January 28, 1991 A Law on Securities Circulation and Stock Exchange was enacted on July 11, 1991, however, this was nullified by President Nazarbayev through a Presidential Decree on March 20, 1994, in anticipation of new laws and formation of a National Commission on



Securities of the Republic of Kazakhstan As a result, there are currently no securities laws in Kazakhstan

Kazakhstan also lacks a Securities and Exchange Commission This is a major obstacle at present, as politics are playing a central role in the formation of a regulatory institution On the one hand, the Council of Ministers is unwilling to approve a commission that reports directly to the President, at the same time, the politics of selecting individual members also delays the formation of the commission In the meantime, the lack of a regulatory body that can formulate and enforce regulations for an effective capital market delays the creation of such a market

Until such time as the Securities and Exchange Commission is established and operational, regulatory oversight for securities trading resides with the Ministry of Finance (Department of State Securities and Financial Markets)

Rules and Regulations of the ASE

The "Temporary Regulations of Securities Trading on the Almaty Stock Exchange," which have been in effect since October 31, 1991, are currently the only provisions regulating the activities of the exchange The rules address many areas of securities market operations, including admission to the exchange and participation in trading, admission of securities, location and time of trading sessions, types of transactions permitted, trading procedures, registration of exchange transactions, clearance and settlement, payment of commissions, cancellation of transactions, procedures for dispute resolution, and penalties However, they do not deal with a number of basic areas for any level of securities industry self-regulation such as qualification of participants, ethical conduct, or financial and operational responsibility

While these rules provide a basic foundation, they need amendments to reflect present conditions and supplements to express long-term policies The procedural sections should be anticipated as subject to constant change as the market evolves

Existing Regulations Governing New Issuance Registration

The Ministry of Finance of the Republic of Kazakhstan is currently charged with the responsibility of overseeing the issuance and registration of securities

The Intradocs consultants met with Galina N Shalgimbaeva, Head of the Department of State Security and Financial Markets, Ministry of Finance, who provided a copy of the "Instruction on Issuance and Registration of Securities of Joint-Stock Companies and Investment Funds in the Republic of Kazakhstan," dated August 13, 1993 This document sets forth the regulations which the Ministry of Finance follows in the registration and issuance of both "closed" (private) and "open" (public) distribution of securities

These documents are quite detailed and contain a substantial amount of data and information As of the date of this report, the consultants have not conducted a detailed analysis of the framework and requirements set forth in these documents They have also not made a determination as to their applicability in current practice or the extent to which they are enforced by the Ministry of Finance, which as previously mentioned is the *de facto* regulatory body in the absence of a Securities and Exchange Commission It is anticipated that once the SEC is established these rules will be subject to change



Constraints

In reviewing the current capital market trends and practices in Kazakhstan, the Intradoss consultants identified a number of key issues which are serious constraints to capital market development and the new issuance process. These are the shortage of tradable securities, both in total and in the hands of entities willing to sell, the consequent inactive secondary market, the need for greater public awareness among potential investors regarding ownership of equities, a limited investor advisory structure, and no institutional infrastructure for public offerings.

- **Inactive Secondary Market**

There is presently no secondary market for equity securities. The two existing stock exchanges (the Almaty Exchange and the Kazakhstan Exchange) are presently inactive, in fact, the KSE has never had any trading activity and exists in form only. As a result, there is little interest or confidence in these exchanges on the part of potential investors. Those enterprises which have been privatized to date are closely held and, to the extent that equity interests transfer, they are essentially private placements.

- **Need for Greater Public Awareness Regarding Ownership of Equities**

The concept of widespread public ownership of equity securities and its potential benefits is understandably not widely understood in Kazakhstan. The mass privatization effort currently in progress has resulted in the creation of approximately 150 Investment Privatization Funds (IPFs). These funds have been aggressively competing for the public's privatization coupons, which in turn are then used to acquire auctioned enterprises. Many of these funds seem to be touting the promise of high dividend returns to coupon holders who invest in their funds. The expectations of large dividend returns through this indirect form of ownership may complicate the ultimate understanding and receptivity of investors to direct ownership of an enterprise through a public offering. The concept that an enterprise has no obligation to pay a dividend to its shareholders and that greater profits may potentially be realized through growth and capital appreciation will require significant public awareness programs as a prelude to a developing market in general, and specifically to the success of initial public offerings.

- **Absence of Institutional Infrastructure for Public Offerings**

There presently is no institutional infrastructure to accommodate an initial public offering of securities. The development of a stock exchange, a community of underwriters, brokers, and dealers, a legal and regulatory framework, accounting guidelines, and a Securities & Exchange Commission, as well as all of the attendant support requirements normally needed to guide the preparation of an IPO, are all concurrently in process. This lack of infrastructure, combined with the general lack of understanding of equity securities ownership, creates a difficult environment in which to orchestrate a successful offering and to identify and attract the key participants in an IPO--namely, the candidate company, underwriter, and investors.



Recommendations

1 General Observations

It is important to remember that both private enterprise ownership and secondary markets for public distributions of such ownership have normal growth patterns over time, with substantially different regulations, procedures, and facilities at each stage of maturity. In free economies, the normal pattern of organization and ownership of business enterprise begins with ownership by one or a few founders, acting either as a sole proprietor, partnership, or corporation, with financing by the founders and their families. Business law is a base for organization at that level. Over time, the need to raise more capital by distributing debt or equity arises, either because, as generations change, extended family members want diversification of their assets or because income generated internally by the business is not sufficient for expansion. This creates the need for a primary market. The final phase is public distribution of debt or equity, which initiates the need for a secondary market and protection of investors by self-regulatory rules for a securities industry and by government law.

Kazakhstan is presently in transition from a largely government-owned business economy. Privatization vouchers are currently the only tradable product, and these are essentially controlled by the Investment Privatization Funds. Kazakhstan is thus at the first stage of ownership described above, with the IPFs as the equivalent of extended families owning businesses in a free economy before true public ownership and secondary markets develop.

It is equally important to bear in mind that in developing capital markets there is very often an acute shortage of supply of securities for the public, even though a large value of securities may have been publicly distributed. This is because more sophisticated institutional investors buy up the securities originally distributed broadly, then hold their blocks because they realize that the true longer-term value of these holdings is far greater than currently evaluated by ordinary investors with limited financial knowledge and imperfect secondary markets. That condition does not change until a community of competent broker/advisors develops to help educate at least the more affluent citizens in personal investing.

Secondary markets in securities also have a normal growth pattern. In the beginning, merchants of diversified products are asked by their customers for assistance in buying or selling securities. They do so by first accepting the securities on consignment and trying to find a contra-party for a commission. Later, these merchants became dealers, buying and selling at a mark-up. To ease the task of finding contra-parties, the broker/dealers organize a central market, or stock exchange.

Initial trading on a stock exchange is by a "call" method, in which only one issue of securities is traded at a time, with trading in the various public issues rotated in a trading session. Trading later becomes "simultaneous" in all traded issues. Both call and simultaneous trading requires a trading manager to control the orderliness of bids and offers. As simultaneous trading increases, the securities traded are broken into groups, each of which is feasible for control by one trading manager. For example, five years ago at the Colombo (Sri Lanka) Stock Exchange there was one employee trading manager. With growth, there are now three employee trading managers for segments of their list. (By comparison, at the New York



Stock Exchange there are about 300 trading managers, or "specialists," who are members of the exchange)

Given this pattern of securities market development worldwide, it appears that assumptions about the level of exchange development and related regulation which will be needed in Kazakhstan in the next few years are unrealistic. Although there is no secondary market, the country has two stock exchanges, both about three years old, one of which has a body of rules but is inactive, and the other never having traded a security. Moreover, the rules of the ASE, which are currently the only provisions regulating the operations of the exchange, appear to be designed for a relatively sophisticated level of public ownership--including the possibility of forward (future) transactions--which has not yet been reached, yet they lack basic self-regulatory provisions.

The consultants' recommendations pertaining to all areas of this project reflect this basic concern and have been formulated in an attempt to provide realistic solutions that will be appropriate to the current stage of capital market development in Kazakhstan.

2 Selection of a Stock Exchange

As described above, the present market in Kazakhstan cannot support two separate exchanges. It will be a challenge to create a market for one exchange under the present conditions. While the Almaty Stock Exchange has the basic foundation, personnel, sound policies and procedures, and initiates regular training for its staff, for a number of reasons--including political considerations--we believe it would be a mistake to select one of the two exchanges over the other as the entity which will receive technical assistance under this project. We therefore strongly recommend a merger of the ASE and the KSE.

- **Political ramifications** the ASE possesses basic operational and technical expertise to run an effective exchange. However, the President of the ASE is not a political man, and his lack of political involvement nearly cost him a seat on the recently formed working committee to create an SEC.

The President of the KSE is a very influential person in Kazakhstan. As a friend of the President and the founder of the country's first bank, he is widely respected. Moreover, he has many influential friends, including Beric Baishev, Chairman of the State Property Fund, and Erlan Orynbasarov, Director of the GKI Information Centre, both of whom have served as Vice Presidents of the KSE.

Although the KSE is not even registered with the Ministry of Finance, every person with whom the Intradoss consultants met discussed both exchanges. The political issue was the topic of discussion of every conversation, and the hope for a single, unified exchange the conclusion of the discussion.

- **Implementation** The Intradoss consultants believe that the limited resources of the two stock exchanges should be pooled together to develop an effective stock exchange. This idea was tested with the President and Vice President of the ASE, and with the Vice President of the KSE, and the response has been promising. While in practice the strong personalities involved will present a challenge, the consultants are confident that with the help of Erlan Orynbasarov of the GKI, who believes in the concept of a single exchange and who has volunteered to bring the two groups together, a merger would be possible.



The legal aspects of implementing a merger would be relatively straightforward and would not require any legislative action

3 Regulatory Aspects

As previously stated, the ASE rules are currently the only provisions regulating the operations of the exchange. The rules appear to have been designed for a relatively sophisticated level of public ownership which will not exist in Kazakhstan for several years. However, they do not deal with areas that are critical for securities industry self-regulation, such as qualification of participants, ethical conduct, and financial and operational responsibility.

Work must begin immediately to conduct a detailed analysis of the ASE rules and to propose additions, deletions, and modifications, with the objective of drafting a set of stock exchange rules that will provide adequate guidance and control in all aspects of day-to-day operations. In this process, the project team must work in tandem with counterpart institutions and advisory groups responsible for developing the securities laws and regulations to ensure that provisions for IPOs are included and that the rules developed for the stock exchange are consistent with the laws that will be enforced by the SEC once it is established.

It should be noted that not all countries provide government regulation by an SEC-type body. Our consultants have worked as securities industry regulators with the Monetary Authority in Singapore and the Finance Ministry in Morocco. An important part of securities broker regulation in the U.S. is delegated by Congress to the Federal Reserve Board. Such a possibility should be considered if politically expedient for Kazakhstan.

NEW ISSUANCE SUPPORT

Objectives and Considerations

The objective of the new issuance support program is to initiate a pilot project, develop appropriate mechanisms, and recommend improvements for transparent and efficient initial public offerings. To serve as a model for future transactions, and to attract the interest of offering participants and investors, it is critical that the pilot IPO is based on a set of rules and regulations and an institutional framework which are perceived by all parties to be a stable foundation for future capital market development.

Given the short timeframe of this project, it has been suggested that even if the new securities laws are not yet in place, the pilot IPO could be launched, supplementing existing provisions by adopting selected regulations established by the U.S. Securities and Exchange Commission. It is our view, however, that potential issuers, underwriters, and investors would be reluctant to commit their resources and efforts to this process when Kazakhstan's securities laws are in the process of being developed and revised. In addition, substantial changes in the rules during the course of the registration and underwriting process could have a very deleterious effect on the confidence of all parties and may result in an unsuccessful effort.

In light of these considerations, the Intrados consultants believe it is imperative that the process of bringing potential issuing companies and underwriters to the point of sale proceed in tandem with



the development of the regulatory framework. In this manner, the pilot IPO will have a greater likelihood of success and can more effectively serve as a role model for subsequent offerings.

Identification of Potential Underwriters

Types of Institutions Considered

As previously stated, not only is there no existing community of underwriters or investment bankers, but there is virtually no understanding of the role of an underwriter in a securities offering.

It is our opinion that the institutions that may potentially serve as underwriters will most likely be found among the financial groups that have also organized and manage the 150 investment privatization funds. These groups have personnel active in acquiring interests in enterprises through the privatization auctions and accordingly have developed at least some form of due diligence and valuation procedures related to those acquisitions, which would be transferable to the underwriting function.

Throughout the world, however, it is standard that personnel organizing underwritings must be separated by what in the U.S. is called a "Chinese Wall" from other parts of the organization giving investment advice or trading for own account. The purpose is to prevent the inside information available to underwriters before a prospectus is published from being used in making investment decisions. It would therefore be improper for the Kazakhstan investment funds themselves to be underwriters. But it should be possible for diversified financial groups which include such funds to organize their human talent in subsidiaries with proper definition and supervision of the varying responsibilities of each.

Considering that the genesis of these investment funds has been the mass privatization effort and that the near future opportunities for this large number of funds is limited, it is not unreasonable to conclude that many of these funds will not endure. From our discussions with fund managers, this opinion seems to be shared, and certain of them predicted that within a year's time only 10% of these funds will exist in their present form.

Accordingly our selection search focuses on the financial groups which in associated funds or elsewhere appear to have underlying personnel competence in this field, plus financial support. This search need not end with a single candidate. Underwritings are normally a joint effort of a substantial number of financial organizations in order to reduce the risk to each. Such groups can be led by either a single manager or several co-managers.

Funds Being Considered

As of the date of this report, we have had preliminary meetings with four investment privatization funds which have been recommended to us as having some degree of prominence in Kazakhstan. The following is a brief discussion of these funds:

- **Alemsystems**

There are presently three investment privatization funds under the Alemsystem name which have been very active in the privatization auctions. It has been represented to us that by the end of 1994, Alemsystems funds will have interests in 300 enterprises.



These funds are part of the Alemsystem Financial-Investment Corporation, which was created in 1992. The shareholders of Alemsystem are approximately 100 of Kazakhstan's largest enterprises. The main shareholder is Alembank Kazakhstan, which is the largest foreign economic bank in the country, conducting more than 80% of the Republic's payments in hard currency. Alemsystem is based in Almaty and has representative offices in all of the major cities of Kazakhstan. There are plans to open representative offices in Frankfurt, Seoul, and San Francisco. The prominence of Alemsystem is evident throughout Almaty by virtue of their extensive advertising and name recognition.

Through our meeting with Valentina S. Kosterina, Director of Fund System and IPF Manager, we have gained some insight into the due diligence process used by Alemsystem prior to investment. Analysts are sent into the field to meet with the prospective enterprise's management, inspect their books and records, and assess the conditions of the existing plant and equipment. Analytical work is performed to evaluate the enterprise's future potential. There is very little reliance placed solely on management representations and/or Ministry of Finance registration data.

- **Butya Capital**

We met with Valikan K. Bekbosynov, General Director, and Igor O. Tayzhanov, Deputy Director.

Butya Capital is also a prominent fund and presently has bought shares in 47 enterprises through the privatization auctions. Approximately half of their enterprises were acquired for speculation purposes and the other half as long-term investments. The concentration of these enterprises has been in chemicals, oil and gas equipment, food processing, and jewelry manufacturing.

We are in the process of gathering further information about Butya Capital's shareholders, their approach to investment analysis, and their future direction.

- **Alatau Invest**

We met with Tolkimbayev Azhdarovitch, Vice President. This fund was among the first to be established (Registration No. 20) and its founders are all well known in Kazakhstan, including the Texas/Kazakhstan Bank, Kazakhstan Commerce Co., and the Republican Foreign Trade Association.

This fund is currently invested in 12 enterprises and controls the maximum limit of 10% of their shares. Of the 12 enterprises, 7 are for long-term investment and 5 are speculative.

This fund is presently a member of the Association of Privatization Funds, which is working to improve legislation governing investment fund activities and their role in privatization.

Most investment decisions are related to the underlying business interests of the fund's founders, but are primarily made on the basis of two criteria:

- companies which are dominant in their industry and important to Kazakhstan, and
- companies whose shares will one day be liquid in the secondary market.



- **Rambek**

Rambek Investment Fund was founded by the Rambek Co , a commercial enterprise involved in oil and gas production, insecticides, cattle breeding, and a network of gas stations According to Erlan E Shinturinov, General Manager, Rambek is one of the 15 largest funds in Kazakhstan

The fund has invested primarily in oil and gas, food, and machinery enterprises At the present time, it has an investment position in 30 enterprises which are spread throughout Kazakhstan The investments have focused primarily on enterprises about which they have some prior knowledge through previous business dealings or through existing relationships, and based upon their analysis of the enterprise's future potential

The fund manager believes they have positioned themselves for future growth and currently have 11 branch "broker/dealers" located in the major regions of Kazakhstan All of these branches are "certified and licensed " As described to us, the positioning of the various branches have all been carefully considered as to their strategic importance

Preliminary Recommendation

All of the funds discussed have expressed at least an initial interest in being considered as a potential underwriter of an initial public offering of stock in an enterprise As previously indicated, our meetings to date with these funds have been of a preliminary nature The primary objectives of these meetings have been

- to introduce ourselves and the goal of our project,
- to gather basic information about the funds,
- to provide a basic overview of the underwriting process, and
- to determine if there is initial interest in developing underwriting expertise and potentially serving as an underwriter in an IPO

More in-depth information must be obtained from any funds selected as a potential underwriters As the success or failure of an IPO is greatly dependent upon the managing underwriter, the selection of a firm should take the following criteria into consideration

- Reputation a highly regarded investment banker will create greater confidence in the stock,
- Distribution capability the company will want to distribute its stock through an underwriter that is sufficiently strong and varied to generate continuing market interest after the IPO,
- Experience with companies in the same or similar industries as the issuer, and
- Research capability the financial community will look to the managing underwriter as a source of information about the new public company

In the context of the existing environment (an emerging capital market structure), the level of success of an IPO will be even more dependent upon the strength, capability, and public recognition of the underwriter than in a mature market environment It is clear to us that Alemsystem presently represents a much stronger presence and name recognition in the financial and business community than any other potential candidate Its name would lend substantial



credibility and confidence in the issuer's securities. On this basis, Alemssystem is deemed to be the best prospect for manager of a successful offering. However, there are other important considerations. The same attributes of size and prominence which give Alemssystem its strength as a potential underwriter also create some degree of sensitivity to its consideration. Namely, there may be a perception of contributing to a monopolistic agenda, which is obviously not desirable.

Accordingly, the consultants would suggest that the potential of Raimbek as an underwriting co-manager be explored. This recommendation is based upon the fund's perceived advantages, namely its size, its name recognition, its due diligence efforts to date, its network of "broker/dealers," and its expressed desire to participate in the future capital market. Moreover, viewing underwriting as a syndicate type activity would substantially alleviate the political problems previously discussed.

Selection of an IPO Candidate

Criteria Normally Considered

In order to put the task of identifying a potential IPO candidate into perspective, it is useful to briefly identify the areas generally considered by an underwriter in evaluating the advisability of issuing public shares as well as pricing the stock. These include the following:

- the company's sales and earnings (current figures, and recent trends),
- adequacy of working capital and cash flow (present and projected),
- management experience, integrity, and quality,
- availability of reliable accounting data,
- future potential of the company,
- comparison to industry, and
- market conditions/timing

Such information is not readily available and often non-existent in an emerging capital market. Information about individual companies in Kazakhstan is extremely difficult to obtain. However, we can classify the types of enterprises that exist in the country.

In the ongoing privatization process, there are basically three categories of enterprises to be divested:

- small (under 200 employees),
- medium (from 200 to 5,000 employees), and
- large (over 5,000 employees)

The small companies are not considered to be viable candidates for an IPO due to their size and poor prospects for future viability. The medium-size companies are targeted for the mass privatization program, in which only investment funds may acquire ownership interests. The large companies are covered under the case-by-case privatization and are also unavailable for public offering, as will be discussed in more detail below.

It appears, then, that an IPO candidate would have to be a firm which has already been privatized and whose current shareholders would be willing to offer shares to the public.



Difficulty of Identification

The Intradoss team met with various officials in the State Property Committee (GKI) and have requested their assistance in identifying a potential candidate for an IPO. These officials have included Saribay Kalmurzaev, Vice Chairman, Abay Biseмбаev, in charge of Privatization Investment Funds, M. Madiev, in charge of Large Company (case-by-case) Privatization, Erlan M. Orynbasarov, Director, GKI Information Centre, Beric Baishev, Chairman, State Privatization Fund, and Andre Mupkovkin, Deputy Chairman, State Privatization Fund.

In addition, the team met with Galina Shalgimbaeva at the Ministry of Finance to request a list of companies on which she has registration information and to ask her assistance in identifying a number of companies which may be potential IPO candidates.

As of the date of this report, we have been provided with the name of only one company as a potential candidate. In certain instances, information offered to us is still in the process of being gathered. In other instances, such as our meeting with Mr. Madiev, we have been informed that the large, case-by-case companies are not likely candidates and that at least 38 of these companies will be sold in private placement through the assistance of an independent consulting company.

We are also in the process of arranging a meeting with Price Waterhouse, which is working on the Capital Market Accounting Project. It is our understanding that they are about to begin transforming the accounting system of 3 enterprises out of 5 which have been identified as candidates for transformation. Price Waterhouse has told us that they would like to have a pool of 10 candidates. It is our intent to explore with them the potential of any of these companies as candidates for an IPO.

We are continuing with our efforts to identify an IPO candidate. However, as this task is complicated in an emerging market, a completion date is difficult to assess. It should also be pointed out that the identification of an enterprise candidate and an underwriter candidate are only the first steps. The joining together of the enterprise with the selected underwriter will be the necessary next step in a complex process of preparation for registration.

Recommendations

1. The pilot IPO should serve as a role model for subsequent IPOs. As we have discussed, there is no perceived incentive for an issuer or underwriters to participate in a difficult and time-consuming process which is based on tentative and uncertain rules. The element of risk this would entail may result in an unsuccessful initial effort which could impair the prospects for subsequent offerings. Therefore, the Intradoss consultants feel that the pilot IPO should not be launched until the formation of the Securities and Exchange Commission is completed, securities laws pertaining to IPOs are formulated, a recognized stock exchange is established, and stock exchange rules pertaining to IPOs are formulated.
2. Given the above, initiatives for stock exchange development and new issuance support must proceed in tandem with the development of securities laws and regulations, particularly those related to listing requirements. Modifications to these laws should be reflected in the training and technical assistance provided to companies and underwriters so that they will be cognizant of the regulatory framework that is being developed for the IPO process.



- 3 At the same time, since this is a new and inexperienced market and the concept of a public offering is not clearly understood, the project team should provide extensive support to potential issuing companies and underwriters in order to bring them to the point of sale. It is also imperative to stimulate the interest of potential investors.
- 4 Technical assistance and training should be provided to potential underwriters to ensure that they have a basic understanding of the following issues:
 - a the underwriting process,
 - b responsibilities of an underwriter before, during, and after a registration,
 - c due diligence procedures and considerations,
 - d expectations from accountants and auditors,
 - e the purpose of comfort letters,
 - f expectations of securities counsel,
 - g timing of events,
 - h types of underwriting agreements (best efforts, firm commitment, and variations of these),
 - i potential rewards (underwriting commissions), and
 - j legal risks
- 5 Training sessions should be conducted for owners of privatized companies to apprise them of the risks and rewards of issuing public shares as a means of capital formation. Following this, targeted technical assistance should be provided to selected companies that are determined to be good candidates for an IPO, in order to bring them to the point of sale.
- 6 Training sessions should be conducted for potential investors to stimulate the public's interest in participating in the stock market.

The proposed training sessions should stimulate interest among potential underwriters, issuers, and investors. They would therefore be an important part of the process of developing informed participants for the first IPO and bringing several candidates to the point of sale.



SECTION II SECURITIES MARKET SYSTEMS

EXISTING INSTITUTIONS

From a systems perspective, the three most important institutions in Kazakhstan are the GKI Information Centre, the Almaty Stock Exchange, and the Kazakhstan Stock Exchange. In general, the capacity and efficiency of the securities market information systems in the country are limited by the lack of an appropriate regulatory framework and operational procedures. In addition, there is a shortage of specialists with the appropriate skills and experience.

The following discussion provides a brief description of the systems that are currently in place at each of the three institutions.

GKI Information Centre

The GKI Information Centre (IC) was organized on November 1, 1993. It operates under the auspices of the State Committee for State Property (GKI), which is the entity responsible for the country's privatization program. The IC system presently includes the Republic Information Centre, or Central IC, with 29 employees, and 21 Regional Information Centres, with a total of 110 employees.

The tasks of the Information Centre include

- creation of a global computerized information system,
- clearance and accounting for privatization coupons,
- clearance and accounting for securities, and
- central governmental depository.

All IC divisions, including the Central IC, are equipped with IBM/PC compatible 386 and 486 computers (350 computers in total). Also, the Central IC has a Motorola fault-tolerant super-mini computer (multi-user UNIX machine).

Communications between the information Centres are provided using special Iskra-2 communication lines (10 lines total, at present). An off-line communications system (E-Mail) is used for data exchange between the Central IC and Regional ICs.

The Information Centre is currently in the process of implementing a "Securities Depository System" project. Initially designed to serve as a coupon clearing system for the mass privatization program, it is now being modified to serve as a universal securities clearing system. Technically, this network could become an important part of the infrastructure for a secondary market, provided that it is made independent of the GKI in order to preclude state control of the system.

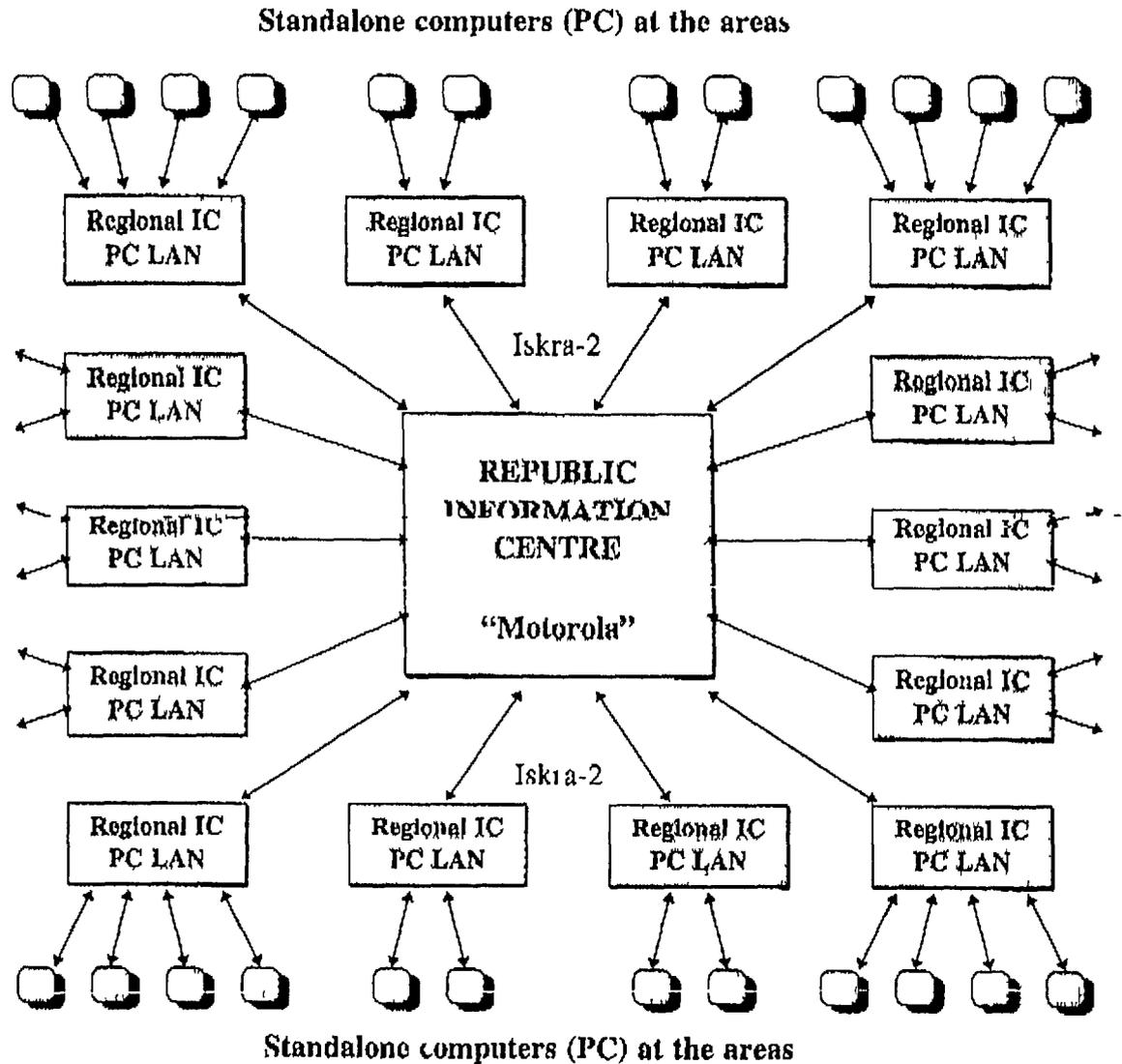
The IC's depository system allows for linkage of securities depositories, stock exchanges, nominal holders of securities, brokers/dealers, and other entities to a central integrated network. The network operates under the control of a single Central Depository that also functions as a Central Communication Node.

The technical structure of the IC's computer network is outlined on the following page. This structure would fit the needs of a national capital markets system and could serve as a basic



communication system if it is made independent of the GKI. While some enhancements would be required, its existence would facilitate the development and implementation process insofar as some of the conceptual and technical tasks have already been tested and solved.

The GKI Information Center Computer Network Structure



Almaty Stock Exchange

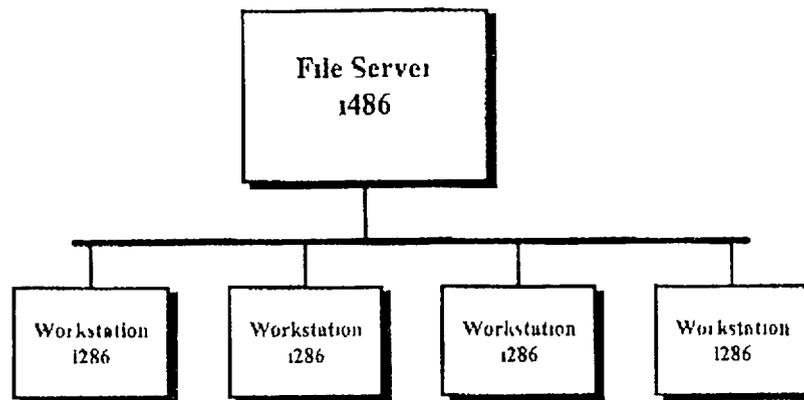
The Almaty Stock Exchange was registered in April 1991. Its staff has practical experience with securities issuance and auctions and has assisted other institutions such as investment funds and banks in areas such as the preparation of registration documents and development of legislative proposals. The ASE has an Information Department, whose specialists have developed several specific applications for the operations of the exchange, including a securities trading information system, an integrated accounting system, and others.



The present ASE computer system is structured as a local area network (i486 computer as a file server, with 5 i286 workstations) It is used only for securities auctions data processing The software was developed and implemented by the IT Department specialists However, this software is not sufficiently comprehensive to do more than keep track of the auction process

The technical structure of the ASE's computer network is outlined below

The Almaty Stock Exchange Computer System



While this structure is sufficient for auctions, it could not support the full range of functions envisioned for the secondary securities market in Kazakhstan However, some aspects of the operational applications developed by the ASE's IT specialists may be appropriate for inclusion in the integrated stock exchange system which will be developed through this project

Kazakhstan Stock Exchange

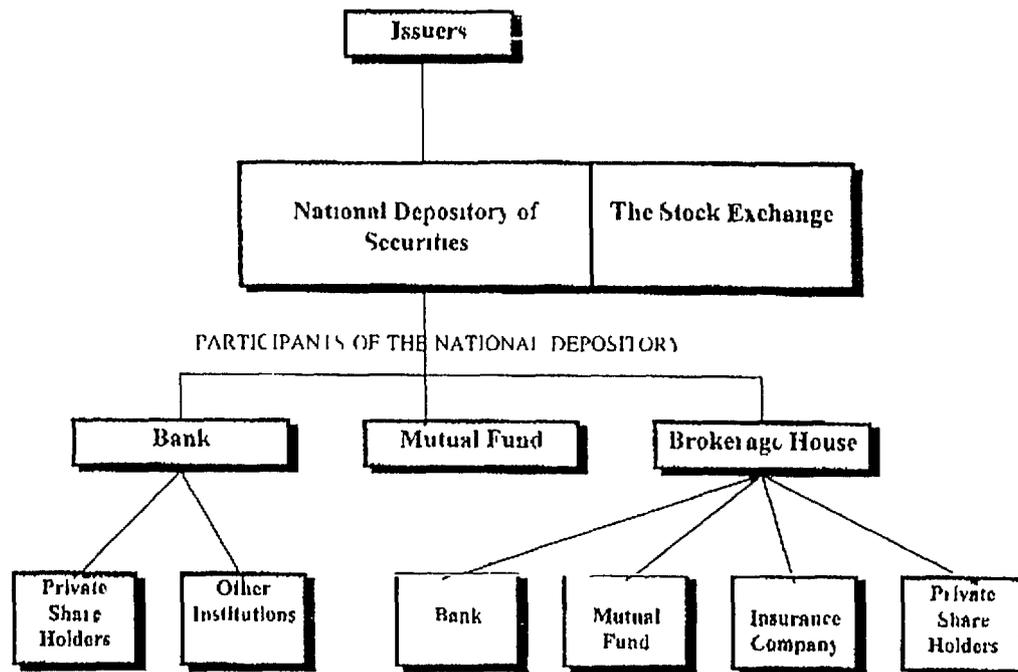
The Kazakhstan Stock Exchange was also created in 1991, however, it has not yet registered with the Ministry of Finance Although the exchange is not yet operational, its key managers have a strong background in capital market theory and have assisted other institutions such as investment funds and banks in areas such as the preparation of registration documents and development of legislative proposals The KSE also has on its staff a number of information specialists who have an excellent understanding of the existing structures as well as some constructive ideas concerning a strategy for future capital market systems development These individuals could contribute to the implementation phase of this project

PROPOSED INSTITUTIONS

One of the most critical institutions in the functioning of a securities market is a central depository, which is currently being developed for Kazakhstan The interrelationship between the depository and the stock exchange is illustrated on the following page



Capital Markets System



A national depository is an essential element of the system. It records changes to the accounts of the brokerage firms and banks, thereby ensuring the confidentiality and anonymity of the transactions. It may be run by the stock exchange, or it may be an independent institution. The depository's functions can be summarized as follows:

- holding securities accounts for its members,
- settlement of financial transactions between stock exchange members, reconciliation of accounts, and supervision of the clearing bank,
- settlement of securities transactions between the members of the Exchange and other financial institutions which are participants of the National Depository,
- registration of the volume of securities issued in the stock exchange trading,
- holding of global securities certificates,
- collection and distribution of interest, dividends and redemption,
- establishment of deposit accounting principles for its members, and
- issuance of depository receipts to the owners of securities for whom it holds deposit accounts

A national depository is currently being developed in Kazakhstan by consultants from KPMG and is not a part of the scope of work for this project. Since it is imperative that the systems designed for the depository and for the stock exchange are compatible, the stock exchange systems should be developed in tandem with those of the depository.



CHARACTERISTICS OF THE MARKET

Present Market

As previously stated, a modern capital market does not yet exist in Kazakhstan. There is no appropriate legislation, no regulatory framework, no depository, no community of brokers/dealers, no underwriters, and no secondary market. The two existing exchanges are presently inactive. Furthermore, there may be fundamental weaknesses in the banking sector which could adversely affect the development of the securities market.

Proposed Market

The trading infrastructure of the proposed capital market has yet to be established. This entails the following components:

- establishment of a Securities and Exchange Commission,
- development and adoption of trading rules and regulations,
- establishment of a national depository,
- creation of a single integrated stock exchange, and
- creation of a community of broker/dealers and underwriters.

As previously discussed, the initiatives under this project will proceed in tandem with the development of the regulatory and institutional framework.

It is likely that trading on the proposed stock exchange will be dematerialized, at least in part (i.e., for some types of securities). This would facilitate securities storage and transfer, it would reduce the cost of market operations, and it would increase the liquidity of securities and the operating efficiency of the exchange. A dematerialized securities market also provides the best protection of investors' interests and enables them to obtain financial information easily and promptly.

REQUIREMENTS FOR AUTOMATION

Before an information system can be designed, the business strategy of the proposed exchange needs to be developed. This should include considerations as to the type of trading that will take place, what information about transactions is expected to be available and when, where trading on the exchange will be permitted and how (i.e., only on the trading floor, or remotely in real time), and whether the market will be completely or partially dematerialized.

Without a clearly defined business strategy, a definition of systems requirements for the stock exchange can at best be only a preliminary guess. The elements which must be considered when defining the requirements include:

- type of trading,
- types of instruments and scope of securities to be traded (equity shares, corporate bonds, government securities, options, etc.),
- time path for introduction of securities,
- typical value of one trade,
- anticipated market capitalization (in emerging markets it has been observed that the value of trading turnover is approximately 10% of the market capitalization),



- anticipated trading volume (retail and wholesale transactions),
- capacity of the market,
- planned/expected growth rate,
- expected number of brokers/dealers and their locations, and
- reporting and control requirements

In addition, a thorough evaluation of the technological capacity and human resources of the exchange must be conducted before the system is designed

Until this information is obtained, it is impossible to make a determination as to specific software, hardware, and installation requirements. However, based on discussions with the parties involved, two preliminary configurations for the automation of the securities market system have been drafted.

Both proposals assume full automation of trading, clearing, and settlement systems using a network computer system. The brokers enter, update, or delete orders from their office terminals throughout the week. During trading sessions, specialists at the exchange use the terminals on the floor to process orders and establish the day's price. Orders are sorted automatically as to their status (executed, partially executed, or not executed). Clearance and settlement is fully automated, including the functions of the depository. All files throughout the system are backed up daily.

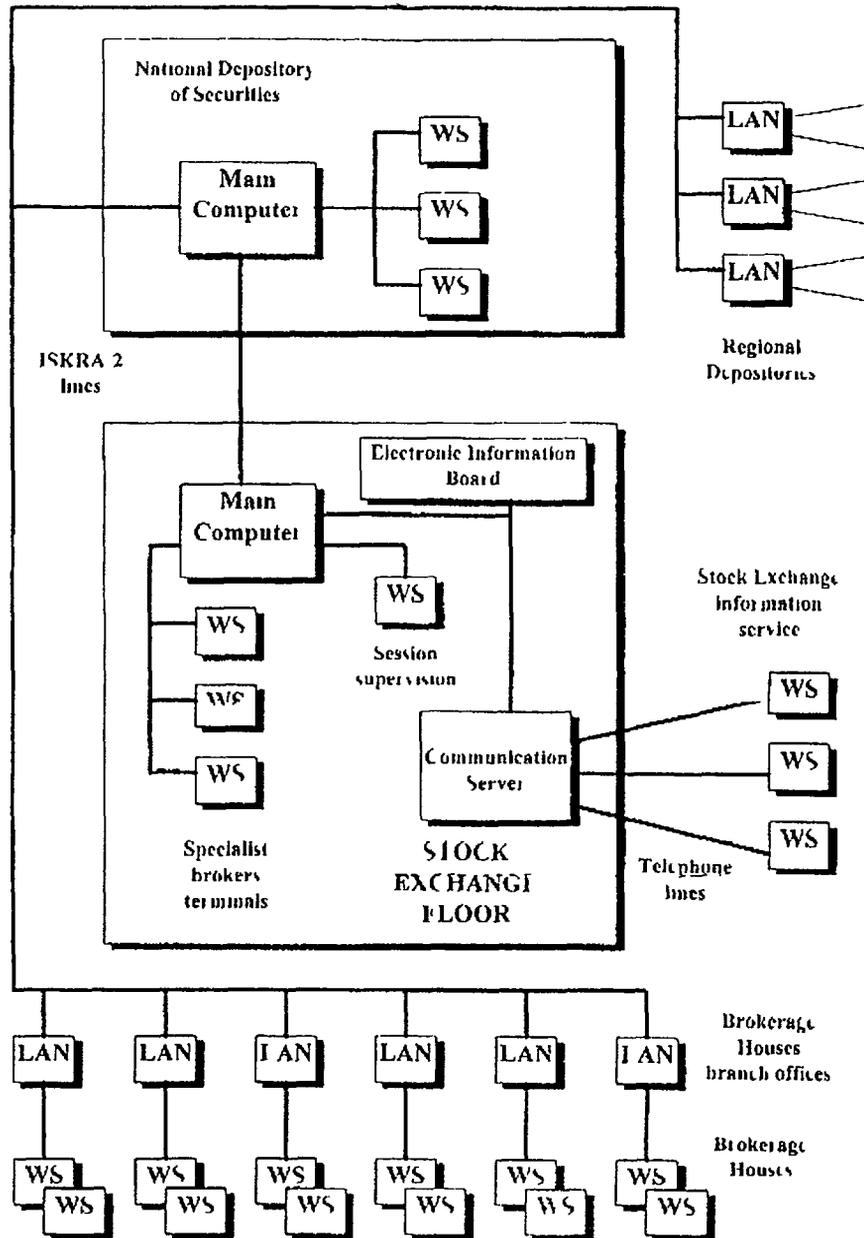
The list of quotations would be formulated automatically at the end of each trading session. This would be linked to an electronic display board on the stock exchange floor and also to the information vendors, making the results of trading available to the public.

In the future, it would be desirable for the exchange to offer an on-line information service. Through their modems, private and institutional investors would have direct and immediate access to trading results and other information concerning turnover, such as corporate actions, as well as stock exchange announcements.

Two examples of how a stock exchange information system in Kazakhstan could be structured are presented on the following pages.



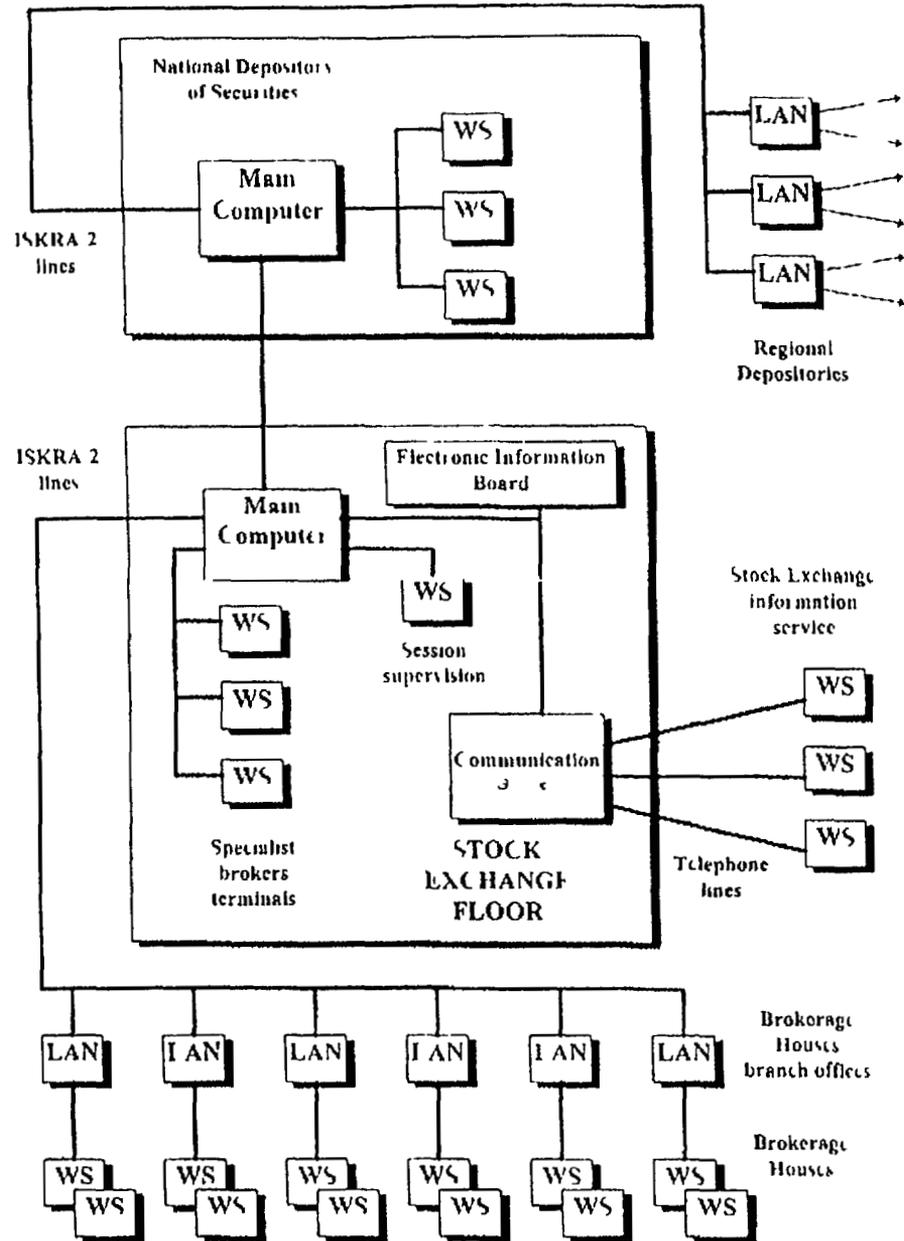
Stock Exchange Computer System (Structure #1)



WS WorkStation LAN Local Area Network



Stock Exchange Computer System (Structure #2)



WS WorkStation LAN Local Area Network



The primary difference between these two structures is that the first uses one regional network for both the brokerage houses and the regional depositories. This structure avoids duplication and provides an essential economy of scale for the cost of communication channels, corresponding equipment, and ongoing expenses such as the leasing of channels.

The second structure supposes two separate regional networks--the first for the regional depositories and a second for the regional brokerage houses. This structure obviously entails higher costs for communication channels and equipment. In addition, it requires a more powerful central computer for the Stock Exchange.

In preliminary discussions, the Almaty Stock Exchange indicated a preference for the second structure. This would provide them with their own regional brokerage network, which would be fully independent from the national depository system.

However, a single regional network may be preferable if it were to utilize the network that has already been developed and tested by the Republic Information Centre. The IC would have to be made independent of the GKI in order to preclude state control of the system, however, if this takes place, it should be technically and politically feasible to use the network for both the national depository and the stock exchange. It should of course be extended to include all areas of the country, and a data security system must be in place to avoid unauthorized data access. Nevertheless, it would be better to make use of this network than to create the same system twice.

The Iskra-2 communication channels utilized by the GKI Information Centre have an excellent quality/price ratio and therefore appear to be one option for the communications requirements in Kazakhstan. Communications between the IC's main computer and the regional depository Centres are already established and work properly (2400 baud connection). Connections between the regional Centres and the computers in outlying areas remain to be established (about 250 communication lines totally). The projected cost for this expansion would be approximately \$65,000.

More detailed specifications regarding the main computer for the stock exchange and other components can only be defined after the exchange's operational procedures have been developed and accepted.



STOCK EXCHANGE DEVELOPMENT AND NEW ISSUANCE SUPPORT FOR THE REPUBLIC OF KAZAKHSTAN

Preliminary Workplans

The following preliminary workplans have been developed with the goal of achieving the overall objectives of this initiative, pursuant to the findings and recommendations of the diagnostic review. It should be noted that the tasks enumerated in these workplans need to be able to respond to changing conditions and may be more comprehensive than will actually be required. Implementation strategies may be affected by circumstances and conditions that are necessary preconditions for exchange development and a successful IPO, but are beyond the control of the parties involved. The time estimates are based on reasonable expectations and do not purport to be either optimistic or conservative.

NOTE The activities listed below are subject to necessary support and assistance from the Government of Kazakhstan to facilitate introduction of these new initiatives. These initiatives also require that the framework of laws and regulations currently being developed by other advisory groups are put in place, as they will govern some of the activities in this plan.

I REGULATORY FRAMEWORK, SELECTION OF STOCK EXCHANGE, AND NEW ISSUANCE SUPPORT

Task	Est Timing	Key Activities
1 Integrate the existing exchanges	6 weeks	<ul style="list-style-type: none">• Coordinate meetings between the exchanges• Facilitate and advise on merger agreements• Facilitate and advise on a combined operations methodology
2 Develop stock exchange rules	8 weeks	<ul style="list-style-type: none">• Analyze existing rules• Assist in the development of new rules
3 Develop a stock exchange business plan	8 weeks	<ul style="list-style-type: none">• Analyze existing assets and resources of the exchange• Prepare a forecast of financial and operations requirements
4 Preparation for IPO	10 weeks	<ul style="list-style-type: none">• Monitor and evaluate new rules and regulations as they are being developed• Develop strategies in response to regulations developed• Identify potential underwriters and issuers for a pilot IPO



Task	Est Timing	Key Activities
5 IPO Registration Procedures	7 weeks	<ul style="list-style-type: none"> • Prepare registration statement • Provide guidance to underwriters • Provide legal and regulatory support
6 Training and Support	5 weeks	<ul style="list-style-type: none"> • Design training modules for potential underwriters, traders, and investors
7 IPO Filing/Training Implementation	4 weeks	<ul style="list-style-type: none"> • Monitor registration • Implement training

The following specific tasks are envisioned for development of the regulatory framework, selection of stock exchange, and new issuance support

- 1 Integrate the Existing Exchanges
 - Coordinate and conduct meetings between both exchanges
 - Assist in resolving issues and concerns of each exchange
 - Facilitate and advise on key elements of a merger agreement
 - Mediate areas of dispute, if any
- 2 Develop Stock Exchange Rules
 - Assemble and analyze existing rules
 - Determine which of the existing rules are compatible with international exchange rules
 - Determine if existing rules are appropriate for an emerging capital market and for Kazakhstan
 - Assist in developing new rules compatible with international markets
 - Work with other advisory groups to ensure that new exchange rules and other rules being established for the proposed regulatory body are complementary
 - Determine if existing listing requirements are appropriate for the exchange
 - Evaluate the adequacy of exchange self regulation and code of conduct
- 3 Develop a Stock Exchange Business Plan
 - Analyze the existing assets and resources of the exchange, including physical facilities, personnel, and communications
 - Assist in determining physical asset requirements
 - Prepare a forecast of financial and operating requirements
 - Assist in developing the stock exchange's entry and annual fees for brokers
 - Assist in drafting listing requirements and fee structure for companies
 - Assist in developing transaction fees
 - Assist in developing a business strategy to deal with growth



4 Preparation for IPO

- Work in tandem with counterpart institutions and advisory groups developing new rules and regulations to ensure that they include provisions for IPOs and that technical assistance provided to issuers and underwriters conforms with these provisions
- Conduct public awareness sessions to introduce potential underwriters and issuers to public offering concepts (Invited participants would include all investment fund managers and directors of privatized companies)
- Identify potential underwriters and issuers with whom to work more closely to bring to the point of sale
- Obtain mutual agreement of identified candidates to proceed

5 IPO Registration Procedures

- All hands meeting underwriter, issuer, securities counsel, and accountants/ auditors meet to discuss responsibilities
- Determine target date for filing registration statement
- Estimate effective date of offering
- Evaluate securities and exchange requirements
- Determine accounting requirements
- Draft registration statement
- Undertake underwriter due diligence
- Define the elements of proposed offering
- Address enterprise (corporate) matters
- Address legal matters pertaining to IPO registration and prepare documents as required
- Undertake marketing of new issue

6 Training and Support

- Develop training manuals for underwriters, traders, and investors

7 IPO Filing/Training Implementation

- Monitor registration review process
- Advise underwriter and issuer on SEC comments
- Conduct training seminars for underwriters, brokers, dealers, and investors



II SECURITIES MARKET SYSTEMS

Task	Est Timing	Key Activities
1 Develop a capital markets system strategy	8 weeks	<ul style="list-style-type: none"> • Determine business strategy • Define system strategy in accordance with business strategy and regulatory framework
2 Determine system requirements	4 weeks	<ul style="list-style-type: none"> • Determination and description of hardware requirements • Determination of software requirements
3 Develop detailed description of system requirements and create detailed implementation workplan	4 weeks	<ul style="list-style-type: none"> • Evaluate existing software packages against system requirements • Make final decision regarding use of existing package or development of customized package • Develop an implementation workplan
4 Develop a plan for system implementation and testing	6 weeks	<ul style="list-style-type: none"> • Implement the selected package • Create testing procedures (scripts)
5 System testing/tuning/errors correction	3 weeks	<ul style="list-style-type: none"> • Test systems according to the scripts • Correct errors and conduct final fine-tuning of systems
6 Training of local staff	4 weeks	<ul style="list-style-type: none"> • Create training modules for the stock exchange staff • Create training modules for brokers/dealers/underwriters • Develop and implement business game

The following specific tasks are envisioned for securities market systems development

1 Develop a Capital Markets System Strategy

- Determine the types of trading, the types of information about transactions that will be required, where trading will be permitted and how, and whether the market will be completely dematerialized
- Develop a stock exchange model

Tasks 2-6 will be significantly affected by the determination of the capital markets system strategy. Accordingly, these are not detailed at this time. The key activities and estimated timing provided in the workplan for tasks 2-6 are based on preliminary estimates of what would usually be required in this situation.



STOCK EXCHANGE DEVELOPMENT AND NEW ISSUANCE SUPPORT FOR THE REPUBLIC OF KAZAKHSTAN

Appendix A

List of Persons Interviewed

USAID

- Lyn Dunn, Private Sector Officer, USAID/Almaty
- Maria Szonert-Binienda, Private Sector Officer, USAID/Washington

State Committee for State Property (GKI)

- Beric Baishev, Chairman, State Privatization Fund
- Abay Bisenbaev, Overseas Privatization Investment Funds
- Saribay Kalmurzaev, Vice Chairman
- M Madiev, in charge of Large Company (case-by-case) Privatization
- Andre Mupkovkin, Deputy Chairman, State Privatization Fund
- Erlan M Orynbasarov, Director, Information Centre

Ministry of Finance

- Galina N Shalgimbaeva, Head, Department of State Security and Financial Markets

GKI Republic Information Centre

- Almas Asilbekov
- Vladimir Morozov, Leading Developer
- Erlan Orynbasarov, IC Director

Kazakhstan Stock Exchange

- Erken Bektaev, Vice President

Almaty Stock Exchange

- Ibray Irkegulov, Head, Information Department
- Kanet Meyrmanov, Vice President
- Bakht Nurembetov, President
- Kairat Turmagambetov, Programmer/Analyst

Alatau Invest

- Tolkimbayev Azhdarovitch, Vice President



Alemsystems

- Valentina S Kosternina, Director of Fund System/Manager IPF

Butya Capital

- Valikan K Bekbosynov, General Director
- Igor O Tayzhanov, Deputy Director

Rambek

- Erlan E Shinturnov, General Manager



STOCK EXCHANGE DEVELOPMENT AND NEW ISSUANCE SUPPORT FOR THE REPUBLIC OF KAZAKHSTAN

Appendix B

Members of the Almaty Stock Exchange

Turan Bank
Joint-stock company "Ile"
Kazdor Bank (Kazakhstan Road Bank)
Aggroprom Bank (agricultural bank)
Kazenergoinvest Bank
"Kazakhstanstroy" concern (Kazakhstan construction)
Kramds Bank
Small enterprise "Zholdas"
Kazcreditsoc Bank
Savings Bank of the Republic of Kazakhstan
Bidergeburt Bank
"Accent Rel"
"Sharapat" (insurance company)
"Megapolios A" (insurance company)
Adilet Bank
Kamkor Bank
Altyndan Bank
Igılık Bank
Interinvest Bank
Amanat Bank
"Stroymaterialy" concern (construction materials)
Cooperative Union of Kazakhstan
Kazcomstroy Bank (Kazakhstan Commercial Construction Bank)
"Almaty" firm
Kazakh Division of Pension Fund
Industrial unit "Tselinenergo"
"Ili"
Kazmetall Bank
"Demeushi" (insurance company)



"Farhad"
"Samur Bank"
"Granit"
"Kazakhstan" (insurance company)
"Montazhspetsstroy"
"Venisa"
"Nadezhda" ("Hope") (insurance company)
Almatycomstroy Bank (Almaty Commercial Construction Bank)
"Kaztechrostroy"
Kaztrans Bank (Kazakhstan Transportation Bank)
Kazpochta Bank (Kazakhstan Mail Bank)
Centra Bank
Taim Bank
"Tchimkenttsyment" (Tchimkent Cement)
Ust-Kamenogorsk SCK (lead/zinc factory)
Association of Coordination with the U N
"Almatyenergo"
Pavlodar Tractor Plant
Academician Suleimenov Fund
"Tasbulatov"
Small enterprise "Standard," Brest, Belorussia
Small enterprise "Nerton," Yakutia, Russia
Brokerage firm "Mzekabni," Tbilisi, Georgia