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The Cart Before the Horse: Anticipatory Securities Regulation in Kazakhstan

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THE CART BEFORE THE HORSE: ANTICIPATORY SECURITIES REGULATION IN KAZAKHSTAN

*Emil Bukhman**

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THE CART BEFORE THE HORSE: ANTICIPATORY SECURITIES REGULATION IN KAZAKHSTAN

Emil Bukhman

I. INTRODUCTION

The fall of communism in the late 1980s and early 1990s has substantially changed the world map. The region once occupied by the Soviet Union now consists of a number of smaller countries (former Soviet Republics), each of which has inherited all the faults and greatness of the former Soviet Empire. The state-controlled economy in the Soviet Union was designed to accumulate a gigantic military power necessary to win a "competition" with the Western world. The general wealth of the Soviet population was irrelevant to this task and, therefore, the consumer goods and services industry was kept at the bottom of the priorities list. These irregularities of the state-controlled economy in the Soviet Union have produced a paradoxical situation in the economies of the former Soviet Republics: while possessing enormous natural resources and highly developed heavy-machinery enterprises, these countries are often unable to supply their population with necessities, such as food and clothing.

The alternative to starvation and decay for these countries has become a fast transition to a market economy. Such transition requires a great deal of money, and former communist countries are now energetically searching for new sources to raise capital. Although international organizations, such as the World Bank or International Monetary Fund (IMF), provide financial aid to the former Soviet Republics,¹ this aid cannot replace economic means of capital raising. To that end, such capital-raising techniques as commercial loans, direct invest-

1. For instance, the loans to Kazakhstan from the World Bank totaled US\$300 million in 1995, and the IMF agreed to a standby agreement worth some US\$300 million. See *Eastern Europe Finance: Georgia, Hungary, Kazakhstan Update*, Economist Intelligence Unit ViewsWire, May 25, 1995, available in LEXIS, World Library, Eiuwns File. The aid from these and other world organizations driven by geopolitical (and perhaps philanthropic) goals is outside the scope of this paper.

ments, and capital markets should be considered seriously, however difficult they may be.

This article concentrates on one of the capital-raising methods: the creation of a securities market. As an example of the introduction of a securities market into the economy of a former communist country, this article examines an experience of the Republic of Kazakhstan, one of the richest of the former Soviet Republics.

Although a securities market appears to be an attractive money-making mechanism, not every country can afford it. Part II of this article argues that Kazakhstan has the economic prerequisites necessary to maintain such a market: issuers of securities willing to offer their stocks to investors; a fast-growing industry of financial intermediaries; and a number of Western institutional investors willing to bid on the Kazakhstani market.

The brief description of the Kazakhstani economy provided in Part II indicates that the country has vast natural resources and a substantial number of highly developed industrial enterprises. These assets are in the process of being privatized as joint stock companies. As a result, the Kazakhstani market has a large supply of securities that can be traded on the market. In addition, the Kazakhstani economy has witnessed the rise of financial institutions necessary to support the market. Part II describes the Kazakh Stock Exchange and the trading activities that provide excellent experience for securities industry professionals in Kazakhstan.

Part II further indicates that the Kazakhstani securities market can and will attract attention of global institutional investors. Applying one of the economic models for the evaluation of emerging markets, Part II posits that investment in Kazakhstani securities may increase both the return and safety of an investment portfolio. To underscore the discussion of economic prerequisites to the creation of a securities market, Part II weighs, from the Kazakhstani perspective, the benefits of capital raising through the securities market against such capital-raising methods as direct investment by a few multinational corporations² or commercial loans.

2. Investments by foreign investment companies presume the existence of liquid securities, and therefore the existence of a securities market. Such investments should be distinguished from direct investments by large foreign corporations that

Having established the existence of economic prerequisites necessary to develop a viable securities market, Part III argues that the only alternative to a government-regulated securities market is undesirable chaotic securities trading that will inhibit, rather than improve, the capital-raising function of the securities market. Such an inference is supported by the experience of other developing countries that have adopted securities regulation in order to bring fairness and order to the securities market, and to help the development of this market.

It should be noted that Kazakhstani securities regulation is necessarily different from the traditional regulatory model existing in developed countries. While securities regulation in the United States and the United Kingdom primarily responds to changing conditions in already existing markets, Kazakhstani regulation is designed to assist in building and developing the market. Therefore, it should anticipate, rather than respond to, market needs. Consequently, Part III argues that the anticipatory nature of the Kazakhstani regulatory scheme poses a particularly difficult task for the government of striking the proper balance between over- and under-regulation.

Keeping in mind the differences between anticipatory and responsive regulation, Part III examines the Kazakhstan Securities Decree, comparing it to the United States securities statutes. Special emphasis is given to the powers of the National Securities Commission (NSC), registration and disclosure requirements, and the definitional section of the Decree. Possible remedies for violations of this law are discussed in the context of the newly adopted Civil Code of the Republic of Kazakhstan. With respect to liabilities, Part III argues that Kazakhstan needs to define and outlaw specifically, rather than in general terms, manipulative and fraudulent practices in its securities industry.

Part III further discusses steps that might be undertaken by the Kazakhstani government to ensure proper functioning of the securities market. Given the specifics of Kazakhstani privatization, the country will require specialized legislation governing the activities of investment companies. Further, Part III gives an overview of the draft of the Investment Company

are, in essence, venture capital investments.

Law that is pending before the Kazakhstani legislature.

The article concludes that with proper legislative and enforcement actions, Kazakhstan can become a very attractive securities market and at the same time raise much-needed capital for its *perestroika*.³

II. ECONOMIC PREREQUISITES TO THE CREATION OF A SECURITIES MARKET IN KAZAKHSTAN

A securities market can be defined in many ways. Most commonly, it is understood as a system (or a place, if we speak about stock exchanges) where sellers and buyers of securities are brought together by financial intermediaries, such as brokers and dealers. Clearly, a securities market is too complex to be comprehensively described by this simple statement. Nonetheless, a securities market can be created, at least arguably, in any country that has business entities willing to raise capital through the issuance and distribution of their securities; investors, foreign or domestic, interested in investing in this market; and financial intermediaries capable of providing avenues for securities trading. Even though the presence of these elements in a national economy may not be sufficient to create a fully functioning market, they constitute building blocks for the creation of a market. An overview of economic conditions in Kazakhstan indicates that these elements are present in its economy.

A. *Issuers*

Kazakhstan has always been one of the wealthiest Soviet Republics. This land, hardly known to an average American, covers a vast territory in Central Asia stretching between Siberia, the Caspian Sea, and China. It is populated by the descendants of the great warriors of the East, by Germans exiled by Stalin from the central parts of Russia during World War II, and by an ethnically diverse, Russian- and Ukrainian-dominated population created by the communist agricultural experiments of the Khrushchev era.⁴ Kazakhstan possesses

3. *Perestroika* is a Russian word meaning remodeling. Introduced into the world political vocabulary by Mikhail Gorbachev, this word symbolizes the transition of former communist countries to a market economy and a democratic society.

4. The ethnic breakdown of the Kazakhstani population is as follows:

enormous natural resources which include coal mines in the north and the Tengiz oil deposits, the largest known oil field in the world, in its western region.⁵ Kazakhstan also mines large quantities of copper, zinc, lead, bauxites, chromites, iron, silver, and gold.⁶ In agriculture, it is the only exporter of wheat among former Soviet Republics.⁷

In addition to vast natural resources, Kazakhstan has a relatively developed industrial sector.⁸ In part, the industrial development in Kazakhstan has been prompted by a need to process its large natural resources and to serve its agricultural sector. Thus, it maintains phosphate mines and fertilizer processing plants.⁹ But most important, only a few years ago, the Kazakhstani economy was a vital part of a Soviet military Goliath. Soviet spaceships were launched from the Baikonur space-launching center located in Kazakhstan.¹⁰ This proximity to the space launching center has led to the creation in Kazakhstan of a highly developed heavy-machinery industry, mostly tied into the old Soviet defense complex.¹¹

All this economic wealth hardly had any impact on the development of a securities market when the Kazakhstani economy was fully controlled by the state. The situation changed, however, when in 1993 Kazakhstan embarked on an ambitious privatization program.¹² As will be described later, this program has been designed to convert state-owned enter-

Kazakh, 41.9%; Russian, 37.0%; Ukrainian, 5.2%; German, 4.7%; and other, 11.2%. See CHARLES UNDELAND & NICHOLAS PLATT, *THE CENTRAL ASIAN REPUBLICS: FRAGMENTS OF EMPIRE, MAGNETS OF WEALTH* 31 (1994).

5. *See id.*

6. *See id.*

7. *See id.*

8. *See id.*

9. *See id.*

10. *See id.* at 4.

11. *See id.* at 33. The Soviet economy was regulated by the Gosplan in a highly arbitrary fashion. Therefore, it is difficult to determine what exactly made Kazakhstan one of the centers of the Soviet military industry. In addition to the benefit of physical proximity to Baikonur, the military industry may have been developed in Kazakhstan because it has large and scarcely populated territories. *See id.* at 31. Proximity to the Soviet-Chinese border may have been another reason. In any event, Kazakhstan does have a fair number of highly developed heavy-machinery enterprises. *See id.* at 33.

12. *See id.* at 34; *Kazakhstan: Privatization Progress*, Nat'l Trade Data Bank Market Repts., Nov. 13, 1993, para. 1, available in LEXIS, Market Library, Mktrpt File [hereinafter *U.S. Embassy Report*]. This report was prepared at the American Embassy in Almaty, Kazakhstan.

prises into private companies organized in a form of joint-stock companies.¹³ These companies are becoming the issuers of securities, thus contributing the first building block of a securities market.

In early 1991, some 37,200 wholly state-owned enterprises operated in Kazakhstan.¹⁴ Of these, the State Property Management Committee ("Goskomimushchestvo" or "GKI")¹⁵ defined 10% as large, 30% as medium-sized, and 60% as small.¹⁶ About 30,000 of these small-scale enterprises have been or will be privatized.¹⁷ The program itself was devised by the Kazakhstani government in cooperation with the World Bank and the United States Agency for International Development (US AID), and is in essence a cash-and-voucher (coupon)-based model, similar to those in other former Soviet Republics.¹⁸ The privatization consists of three parts: small scale,¹⁹ mass,²⁰ and a case-by-case privatization of large and special enterprises.²¹ Small-scale enterprises are those with under 200 employees and a book value of less than five million rubles of fixed capital as of January 1, 1993.²² Small-scale enterprises are sold for cash and coupons (in equal portions) in open auctions.²³ Since bidders are required to pay one-half of the purchase price in coupons, buyers are faced with a tremendous burden of finding enough coupon sellers.²⁴

The mass privatization program provides for the sale or divestiture of approximately 8,000 state-owned enterprises with between 200 and 5,000 employees.²⁵ These enterprises will be set up as 100% state-owned joint stock companies, after which the GKI will sell at least 51% of their shares at specialized voucher auctions.²⁶ Under the mass privatization model,

13. See *infra* note 28 and accompanying text.

14. See *U.S. Embassy Report*, *supra* note 12, para. 11.

15. See *id.* para. 6.

16. See *id.* para. 11.

17. See *id.* para. 8.

18. See *id.* paras. 1, 2, 7.

19. See *id.* paras. 12-23.

20. See *id.* paras. 24-27.

21. See *id.* paras. 28-29.

22. See *id.* para. 12.

23. See *id.* para. 13.

24. See *id.* para. 15.

25. See *id.* para. 24.

26. See *id.* paras. 24-25.

citizens will be able to join their vouchers in investment funds and collectively bid for stakes in the enterprises.²⁷ About 144 private investment funds are now bidding on behalf of the citizens in privatization auctions.²⁸ Foreigners are not allowed to take part in this privatization (although they certainly can buy already-privatized shares in the secondary market).²⁹ Finally, the case-by-case privatization is designed to privatize approximately 200-250 very large enterprises with more than 5,000 employees, and about 1,000 enterprises that require special regulatory involvement (like those exploiting natural resources).³⁰ The privatization of these companies has no pre-designed plan and will be done on a case-by-case basis because of the financial and regulatory uniqueness of each such enterprise.³¹ Foreigners can bid for such enterprises even at the first stage of privatization, without waiting for secondary trading.³² For instance, in 1993, Philip Morris bought a 49% stake in the Kazakhstan Tobacco Company.³³

By October 1994, small-scale privatization was practically completed, and virtually all small enterprises had become joint-stock companies controlled by shareholders.³⁴ Mass privatization is under way, and in the immediate future most of the remaining state-controlled enterprises will also become joint-stock companies.³⁵ The voucher system of privatization has created a substantial number of publicly held issuers and has spread the ownership of these companies among the members of the general public, making privatized enterprises publicly held companies. As a result, the first necessary condition for the creation of a securities market in Kazakhstan—the existence of issuers of securities—has been satisfied.

27. See *id.* para. 26.

28. See James Kynge, *Kazakhstan Plans Privatization, Stock Market*, Reuter Textline, Mar. 14, 1994, available in LEXIS, News Library, Ttxtnws File.

29. See *id.*

30. See *U.S. Embassy Report*, *supra* note 12, para. 28.

31. See *id.*

32. See Kynge, *supra* note 28.

33. See *U.S. Embassy Report*, *supra* note 12, para. 29.

34. See *Kazakhstan: Privatization Does Not Solve Economic Problems*, Reuter Textline, Oct. 1, 1994, available in LEXIS, News Library, Ttxtnws File.

35. See *id.*

B. Financial Intermediaries

Measured by the standards of a developed securities market, the system of financial intermediation is virtually nonexistent in Kazakhstan. Nevertheless, the securities industry in the country is growing steadily and is developing the expertise and sophistication necessary to facilitate a market in securities. Initially, two stock exchanges were created in Kazakhstan: the Almaty and the Kazakh Stock Exchanges.³⁶ For purposes of economy of scale and most efficient pricing and liquidity, the drafters of the Kazakhstani securities laws suggested that Kazakhstan have only one stock exchange.³⁷ As a result, both stock exchanges were merged into one Kazakh Stock Exchange. Thus, Kazakhstan has created a marketplace for securities trading.

Although the Kazakh Stock Exchange can hardly be compared to the New York or London Stock Exchanges, its floor maintains some trading activities. The members of the Kazakh Stock Exchange trade mostly in short-term debt instruments known as *veksels* or bills of exchange.³⁸ Bills of exchange are currently in use in Kazakhstan and their use is growing because these instruments secure the underlying assets of privatized enterprises.³⁹ Owing to their extensive use in privatization, bills of exchange are traded very actively.⁴⁰

With respect to the active trading in bills of exchange, the Kazakhstani experience is not unique. In the 1950s and 1960s in Brazil, an accelerated rate of inflation boosted the development of a public market in bills of exchange.⁴¹ This market had an enormous impact on the Brazilian capital markets; it created, for the first time, "the nucleus of a securities indus-

36. Interview with Mark Berger, Member of the U.S. Team of Drafters of Kazakhstani Securities Laws, in New York, N.Y. (Feb. 1996) [hereinafter Berger Interview].

37. See *Structure of a Secondary Market in Kazakhstan*, INTRADOS (Int'l Mgmt. Group, Almaty, Kazakhstan) (1995) [hereinafter *Structure of a Secondary Market*] (on file with the *Brooklyn Journal of International Law*).

38. Berger Interview, *supra* note 36.

39. See Memorandum from Greg Vojack to Babak Movaheidi (Oct. 17, 1994) [hereinafter Vojack Memorandum on *Veksels*] (on file with the *Brooklyn Journal of International Law*).

40. See *id.*

41. See Norman S. Poser, *Securities Regulation in Developing Countries: The Brazilian Experience*, 52 VA. L. REV. 1283, 1289 (1966).

try.⁴² Similarly, active trading in bills of exchange in Kazakhstan helps Kazakhstani securities professionals develop invaluable experience, which may later be used in securities trading.

While Kazakhstani broker-dealers have learned the basics of securities trading through their participation in the bills of exchange market, the wide use of investment funds in the Kazakhstani privatization program has brought investment advisors and portfolio managers into existence. These categories of securities professionals learn their trade in a process of managing the investment funds that bid for newly privatized enterprises. Even though these managers of Kazakhstani investment funds, unlike their Western counterparts, do not have to deal with all the complexities of modern investment strategies, their primary task of composing a financially sound investment portfolio is basically the same as that of the manager of Vanguard or Fidelity.

As this brief overview of the Kazakhstani securities industry indicates, Kazakhstani financial institutions are already capable of handling simple tasks associated with securities trading. Furthermore, the Kazakhstani securities industry has received assistance from its more experienced Western colleagues. In 1992, the Kazakhstani government hired the Rothschild Group as investment advisors to the country on the development of its natural resources, privatization of its industries, creation of its capital markets, and promotion of securities underwriting.⁴³ One of the tasks delegated to the Rothschild Group is advising Kazakhstani enterprises on corporate finance, commercial credit, and investment banking.⁴⁴ Such "tutoring" of Kazakhstani securities professionals by a prominent Western banker, aided by economic conditions of the Kazakhstani market, gives Kazakhstani financial institutions a practical experience in dealing with securities and facilitates the development of a securities industry in Kazakhstan.

In sum, the Kazakhstani securities industry is not simply an ambitious dream of the Kazakhstani government, it is be-

42. *Id.*

43. See *Kazakhstan [sic] Signs Agreement with Rothschild Group to Advise on Development of Its Natural Resources and Privatization of Its Industries*, PR Newswire, May 21, 1992, available in LEXIS, News Library, Wires File.

44. See *id.*

coming an economic reality. As it develops its expertise through trading in short-term instruments and participation in the privatization of investment funds, the industry provides a viable system for bringing together buyers and sellers of securities, thus satisfying the second condition necessary for the creation of a securities market.

C. Investors

The privatization of state-controlled enterprises has created widespread share ownership in Kazakhstan.⁴⁵ As a result, the nation has witnessed the rise of a class of domestic investors who may be willing to trade their shares. Furthermore, the investment funds, which are structured in a way very similar to that of mutual funds, will most likely trade in privatized stock to create marketable investment portfolios.

The appearance of domestic investors on the Kazakhstani market is certainly relevant to the creation of a securities market. However, there is no guarantee that the owners of privatized shares in Kazakhstan will trade them instead of holding these shares in the hope of overcoming inflation. Moreover, domestic investors that may exist in Kazakhstan do not have enough savings to compensate for a lack of foreign capital injections. As to the individual foreign investors who do not have the ability to obtain adequate information about Kazakhstani companies, the Kazakhstani market is too dangerous for them. Therefore, the existence of a securities market in Kazakhstan depends on whether global institutional investors will be willing to invest in it.

A number of factors indicate that the Kazakhstani market is capable of attracting such global institutional investors. In the past three decades, the world's securities markets have undergone the process of internationalization.⁴⁶ Global investors have been looking for new markets to diversify their portfolios and to obtain higher rates of return.⁴⁷ To that end, more

45. See *supra* text accompanying notes 34-35.

46. See *Internationalization of the Securities Markets*, Exchange Act. Rel. No. 21,958, [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,759 (Apr. 18, 1985).

47. "[D]uring the years spanning 1980 to 1989, total U.S. purchases and sales of securities abroad grew from \$17.9 billion to \$230.3 billion." Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERVS. RES. 349, 357 (1990).

and more investors have turned their eyes toward the emerging markets, a *terra incognita* that offers rich rewards to intrepid financial conquistadors of the twentieth century who defy the risks of the unknown.⁴⁸ Given the interest in the emerging markets on the part of the global institutional investors, the Kazakhstani market may well become their next investment target. In order to support this proposition, the following discussion of emerging markets in general is offered.

1. Emerging Markets

Although emerging markets encompass a variety of different economic systems, they all share certain common features. An emerging market is a market that: (1) has securities that trade in a public market; (2) is not a developed market (as defined by countries covered within the Morgan Stanley Capital International Indices or Financial Times Indices); (3) is of interest to global institutional investors; and (4) has a reliable source of data.⁴⁹ Most economists agree that investing in emerging markets increases both the returns and—contrary to common perceptions—the safety of the portfolio.⁵⁰ A study by economists Divecha, Drach, and Stefek found that a global investor who, over the five-year period studied, invested 20% in an emerging markets index fund, would have reduced overall annual portfolio risk from 18.3% to 17.5% while increasing annual return from 12.6% to 14.7%.⁵¹

A few factors contribute to this rather unexpected result. First, while the emerging markets are more volatile than the developed markets, they tend to be relatively uncorrelated with each other and other developed markets.⁵² For example, in October, 1987, while the world's markets were crashing, the

48. Although U.S. stocks produced returns averaging 27% in 1995, some analysts believe that many foreign markets, and emerging markets in particular, will outperform the markets in the United States over the next 18 months. See Mark Bautz, *Where in the World to Invest Now*, MONEY, Oct. 1995, at 138, 139. Moreover, over the period from 1987 to 1991, the International Finance Corporations Emerging Markets Composite Index was 19.7%, as compared to 12.6% for the Financial Times World Index. See Arjun B. Divecha et al., *Emerging Markets: A Quantitative Perspective*, J. PORTFOLIO MGMT., Fall 1992, at 41, 42.

49. See Divecha et al., *supra* note 48, at 42.

50. See *id.* at 41.

51. *Id.*

52. See *id.*

Indian stock market was up modestly.⁵³ This low correlation can be explained by the fact that most of the emerging markets have closed economies whose ties with the world markets are very weak.⁵⁴

Homogeneity within an emerging market is another important factor contributing to the reduction of risk of the portfolio that contains emerging-markets investments. In other words, when the market moves, there is a strong tendency for all stocks in the market to move with it.⁵⁵ This phenomenon occurs in part due to a high market concentration where a few large companies so dominate the market that they are, in effect, the market.⁵⁶ Thus, if an emerging market moves up or down, all stocks in the market will probably move in the same direction. From the investor's viewpoint, the homogeneity phenomenon suggests that the investor in emerging markets has to pick the right market at the right time rather than picking "good" stocks within a market.⁵⁷

The relatively low cross-market correlation and high market homogeneity in the emerging markets offer an opportunity for diversification and overall portfolio risk reduction.⁵⁸ The flip side of low correlations across these markets and high homogeneity within a market is that country selection becomes the most important task for a portfolio manager.⁵⁹ Clearly, the major consideration in selecting one emerging market over another is the rate of return it produces.⁶⁰

53. *See id.* at 48. Numerically, the average correlation among the developed markets over the five-year period studied was 0.49. *See id.* The average correlation among the emerging markets was 0.07 over the same period of time, and 89 out of 276 correlations were negative. *See id.* at 47-48. Moreover, the average correlation with the developed markets was negative 0.01 (-0.01). *See id.* at 49.

54. *See id.* at 48.

55. *See id.* at 45. Concentration of the market is calculated by the following formula:

$$\text{Concentration} = [(N/N - 1) \times \Sigma(h_n - 1/N)^2]^{0.5},$$

where:

N = Total number of stocks or industries, and

h_n = Weight in asset (or industry) n.

Based on this formula, the concentration of an extremely diversified market like the United States is 0.08, whereas the average for the emerging markets of Taiwan, Korea, Thailand, and Malaysia is 0.13. *See id.*

56. *See id.*

57. *See id.* at 47.

58. *See id.* at 50.

59. *See id.*

60. *See id.* The high homogeneity of the market allows us to talk about the

Correctly selecting emerging markets indeed pays off. In 1990, the Venezuelan stock market rose about 450% in U.S. dollar terms.⁶¹ On the other hand, bad selection can be as harmful as good selection can be rewarding. For instance, in 1990 the Taiwanese Stock Exchange index began the year at about the 5,000 level, went up to 12,600 during the first quarter, and then plummeted to near 2,500 during the third quarter.⁶² These numbers show that emerging markets are extremely volatile, and it is necessary to form some model to determine the returns of such markets.⁶³

For that purpose, conventional linear models are not always workable in application to the emerging markets. Campbell Harvey found in his studies that only one of twenty emerging markets had a beta greater than one when measured against a world equity market return,⁶⁴ yet common sense tells us that emerging markets have large risk exposure. The reason why the beta model fails to describe accurately the emerging markets is that the beta model operates on the assumption that all capital markets are completely integrated.⁶⁵ As we have already seen, the emerging markets with the low cross-market correlation are hardly integrated in the world economy. Therefore, Erb, Harvey, and Viskanta offered a different model for determining the returns of the emerging markets, a model based on credit risk ratings.⁶⁶ This approach

rate of return for the market as a whole, rather than the rate of return of individual stocks or industries. *See supra* note 55 and accompanying text.

61. *See Divecha et al., supra* note 48, at 42.

62. *See id.*

63. Divecha, Drach, and Stefek measured the returns of emerging markets using the following model: Excess Return (over the risk-free return) = Currency Return - Local Excess Return + Cross-Product. *See id.* at 43. Numerically, this formula looks like the following:

$$\text{Excess Return} = (r_x + r_n - r_f) - (r_1 - r_n) + r_x \times r_1,$$

where r_f = the risk-free rate of return in the country of the investor, and r_n = the risk-free rate in the market where the investment is made. *See id.*

Using this model, the authors concluded that "[t]he overall portion of variance explained by the emerging markets model (adjusted R^2) is 50%, as compared with 38% for a similar model that covers the developed markets (countries covered by the Financial Times Indices)." *Id.* at 44.

64. Campbell R. Harvey, *Predictable Risk and Returns in Emerging Markets*, 8 REV. FIN. STUD. 773, 791 (1995).

65. *See* Claude B. Erb et al., *Country Risk and Global Equity Selection*, J. PORTFOLIO MGMT., Winter 1995, at 74, 80.

66. *Id.* at 75.

gives a better picture of market return because credit risk ratings consider simultaneously political and other expropriation risks, inflation and exchange rate volatility/controls, the industrial portfolio and its economic viability, sensitivity to global economic shocks, and many other factors.⁶⁷

The studies conducted by Erb, Harvey, and Viskanta showed a negative correlation between credit ratings and average returns.⁶⁸ Thus, the highest credit risk countries, with an average credit risk rating of 33.2, have an average annual return of 27.3%, annual volatility of 17.1%, and an average dividend yield of 5.1%.⁶⁹ At the same time, the low credit risk countries, with an average rating of 90.2, have an average annual return of 15.7%, annual volatility of 15.0%, and an average dividend yield of 3.5%.⁷⁰ In other words, the riskier the country is in terms of its credit rating, the higher the returns that can be expected on its market.

In sum, economists have drawn an attractive picture of investment in the emerging markets. The question remains, however, whether Kazakhstan qualifies as an emerging market and hence can offer global investors the same advantages as the rest of this group. In comparing the features of the emerging markets discussed above with the peculiarities of the Kazakhstani economy, this article answers this question in the affirmative.

Indeed, the application of the emerging markets definition⁷¹ to Kazakhstan indicates that it has a potential to become an emerging market. First, Kazakhstan is certainly not a developed market. Second, as it has been shown in this article, Kazakhstan has securities that can be traded in a public market.⁷² As to a reliable source of data, a number of leading accounting and law firms, such as Price Waterhouse, Arthur

67. *See id.* Another advantage of this model is that credit risk rating, unlike the traditional risk measurement methods, is forward-looking. In other words, this model is not based on the past prices of securities, but rather uses the credit forecast to extrapolate the future development of the market. *See id.*

68. *See id.* at 76.

69. *See id.* at 79 fig.3.

70. *See id.* The International Finance Corporation data indicates an even wider gap in performance: 34.3% average annual return for the highest credit risk countries with the average credit rating of 27.2, versus 7.9% annual return for lowest credit risk countries with the average credit rating of 61.9. *See id.*

71. *See supra* note 49 and accompanying text.

72. *See supra* Part II.A-B.

Andersen, Coopers & Lybrand, and Clifford Chance, have established their presence in Kazakhstan.⁷³ Thus, Kazakhstan satisfies at least three prongs of the emerging market definition. But most important, Kazakhstan has the potential to satisfy the fourth prong of the definition: the country can, and does, attract the attention of global institutional investors.

2. Rate of Return

The Kazakhstani market can provide high rates of return. Studies of Kazakhstani economic and political conditions show that Kazakhstan is a high-credit-risk country. According to the analysis conducted by the Economist Intelligence Unit (EIU), Kazakhstan scored a rate of 75.⁷⁴ This number gives a fairly accurate picture of the country's economy and can serve as a starting point for calculating the annual return of the Kazakhstani market. Indeed, the EIU took into consideration the overall situation in Kazakhstan: the political victory of President Nursultan Nasarbaev in the August 30, 1995 referendum; 9.2% Gross Domestic Product (GDP); a mass privatization program; reduction of inflation rates (2.4% in September 1995, as compared to 9.7% in September 1994); and a slowdown in the overall decline in industrial production (from 22.4% in January 1995 to 10.8% in August 1995).⁷⁵ The EIU Credit Rating Service also considered the fact that Kazakhstan has a low foreign debt burden. The EIU estimated that by 1997, the debt/GDP ratio will be only 5.4%, with a debt-service ratio of 8.7%.⁷⁶

Now, using the model developed by Erb, Harvey, and Viskanta,⁷⁷ we can determine the average annual return. It

73. See Helen Davidson, *Kazakhstan: Asian Gateway to Profits*, SUN. TIMES (London), Apr. 16, 1995 available in LEXIS, News Library, Txtnews File.

74. See *Kazakhstan Update*, Economist Intelligence Unit, Oct. 20, 1995, available in LEXIS, World Library, Eiuunws File [hereinafter *Kazakhstan Update*]. It has to be noted that the EIU credit risk rating uses the opposite scale than the one used by Erb, Harvey, and Viskanta. See *supra* notes 66-70 and accompanying text. The EIU's Country Risk Service ratings range from zero for the least risky "A" category countries to 100 for the highest risk "E" group. See Ven Sreenivasan, *Asian Economies Except China the Least Risky, Says EIU*, BUS. TIMES, Dec. 20, 1994, at 3, available in LEXIS, News Library, Papers File.

75. See *Kazakhstan Update*, *supra* note 74.

76. See *id.*

77. See *supra* notes 66-70 and accompanying text.

should be noted at the outset that Erb, Harvey, and Viskanta rated each country's credit risk on a scale of zero to 100, with 100 representing the smallest risk of default.⁷⁸ In contrast, the EIU's scale is the reverse of that used by Erb, Harvey, and Viskanta, with the rating of 100 to be the highest credit risk.⁷⁹ Consequently, for purposes of consistency, the EIU's credit risk number has been adjusted to the Erb-Harvey-Viskanta model. The resulting rate is thus 25. Using this number, we can estimate the rate of return for the Kazakhstani market, by extrapolating the rates of returns of the countries that have similar credit ratings on the Erb-Harvey-Viskanta scale.

The countries that will be closest to each other on the scale will be Pakistan (which is rated by the International Finance Corporation at 26.4) and Zimbabwe, which is rated at 24.5.⁸⁰ The compound annual rates of return for these two countries are 24.3% and 6.0%, respectively.⁸¹ These numbers provide very little help because the spread between their respective returns exceed the spread between the returns of low and high credit risk countries. Despite an apparent inconsistency with the credit risk investment model, such can be explained.⁸² Zimbabwe, unlike many other emerging markets, has special classes of shares and particularly tight restrictions on the repatriation of capital.⁸³ These restrictions make Zimbabwe's portfolio not investable and, consequently, of no interest to global institutional investors, which explains the low rates of return.⁸⁴

Thus, Kazakhstan has an option of tightening its foreign investment policies and significantly lowering market investability. As a result, Kazakhstan would follow the pattern of the Zimbabwe market with its 6% annual returns; such a low return is of no interest to the institutional investors who can fare much better in U.S. blue chip stocks. Alternatively, Kazakhstan can create a favorable environment for foreign investments and become a very attractive emerging market

78. Erb et al., *supra* note 65, at 75.

79. See Sreenivasan, *supra* note 74.

80. See Erb et al., *supra* note 65, at 76-77 fig.1.

81. See *id.*

82. See *id.* at 81.

83. See *id.*

84. See *id.*

with a compound annual rate of return of 24%—the rate of return that, according to Erb, Harvey, and Viskanta studies, conforms to the credit risk rating similar to that of Kazakhstan. Certain facts circumstantially indicate that Kazakhstan is steadily moving in the direction of the second option. Under the Kazakhstan foreign investment law, foreign investments can be in the form of stock holdings in Kazakhstani enterprises and in the form of other securities.⁸⁵ This law guarantees foreign investors the right to transfer freely abroad the income derived from their activities in Kazakhstan.⁸⁶ Furthermore, the law completely rules out any possibility of expropriations.⁸⁷ The law also eliminates dual taxation, in accordance with tax agreements entered into by Kazakhstan with other countries,⁸⁸ and allows international binding arbitration of commercial disputes.⁸⁹ Finally, the law not only gives foreign investors national treatment,⁹⁰ but also provides state guarantees for their investments.⁹¹ The text of the law indicates that Kazakhstan chose an open door policy with respect to foreign investments. Consequently, Kazakhstan's investment portfolio, unlike that of Zimbabwe,⁹² is not uninvestable, and unlike the anomalous credit rate/annual return correlation on the closed Zimbabwe market, Kazakhstan fits into the model developed by Erb, Harvey, and

85. See Law on Foreign Investments, art. 1, adopted Dec. 27, 1994 (Kaz.), translated in THE CIVIL CODE OF KAZAKHSTAN 230, 230 (W.E. Butler trans., 1995) [hereinafter Law on Foreign Investments]. This recently adopted law provides that "[f]oreign investments may be contributed to any objects and types of activity not prohibited for such investments by legislative acts of the Republic Kazakhstan." *Id.* art. 2, at 231; see also Vladimir Savin, *Kazakhstan: Foreign Investment Legislation*, Reuters, Foreign Trade (USSR), Jan. 1, 1993, available in LEXIS, News Library, Txtaws File.

86. See Law on Foreign Investments, *supra* note 85, art. 11(2), at 236-37.

87. See *id.* art. 7, at 235.

88. See Savin, *supra* note 85. The term "dual taxation" describes a situation when foreigners doing business in Country A pay taxes on the income earned in Country A twice: First, in Country A, and then in their home country. Since dual taxation may impede the development of international trade, many countries try to avoid it by entering into tax agreements that provide tax credits for income earned abroad. See *id.*; see also Law on Foreign Investments, *supra* note 85, art. 22, at 242.

89. See Law on Foreign Investments, *supra* note 85, art. 27, at 244-45.

90. See *id.* art. 4(1), at 232.

91. See *id.* arts. 5-6, 8, at 233-35.

92. See *supra* notes 83-84 and accompanying text.

Viskanta.⁹³ Therefore, we may assume that the Kazakhstani market can generate substantial annual returns in the range of 24%, similar to other emerging markets, with the same credit risk ratings, surveyed by Erb, Harvey, and Viskanta.

This point of view is supported by some investment fund managers. As of April 1995, two English investment funds, Framlington and Flemings, were about to launch the first funds to invest in Kazakhstan.⁹⁴ Framlington has presented to institutional investors a fund that aims to invest between US\$30 to \$40 million dollars in Kazakhstan.⁹⁵ Peter Phelps, the director of Framlington's Central Asia desk, has said that "[f]rom an investment perspective, Kazakhstan is reasonably attractive. . . . Politically, the region is fundamentally stable although they may not win brownie points for democracy."⁹⁶ In contrast, Flemings has set up a Kazakhstan equity fund aimed at small investors.⁹⁷ According to the fund manager, James Oates, "Bearing in mind the risks, we believe that there is value in Kazakhstan. . . . The big story is oil and gas, and the presence of such high-profile investors as Chevron helps."⁹⁸

The discussion of investment opportunities in Kazakhstan leads to the conclusion that its market is attractive to both foreign and domestic investors. The wide-scale investment

93. See *supra* notes 66-70 and accompanying text.

94. See Davidson, *supra* note 73.

95. See *id.*

96. *Id.* The country is considered politically stable by Western businessmen interested in the Kazakhstani market, even though on March 11, 1995, President Nasarbaev dissolved the Parliament. See Douglas Busvine, *Kazakhstan: Foreign Investors Relaxed About Kazakhstan*, Reuter Textline, Mar. 13, 1995, available in LEXIS, Wires Library, Txttee File. But see *infra* note 147. According to Bob Williams, one of the officers of Tengizchevroil, a joint venture between Kazakhstan and Chevron Oil, there is no reason for foreign investors to feel insecure since all the agreements and licenses remained in effect. See Busvine, *supra*. Moreover, the U.S. Ambassador in Kazakhstan, William Courtney, felt that the developments could even help reinforce the rule of law in Kazakhstan after the Kazakhstani Constitutional Court ruled that the March 1994 elections were undemocratic. See *id.*

97. See Davidson, *supra* note 73.

98. *Id.* Chevron has a 50% stake in Tengiz, the world's single biggest oil deposit, which is capable of producing 750,000 barrels of crude oil a day. See Busvine, *supra* note 96. Chevron has already spent about US\$1 billion in Tengiz. See Andrew Higgins, *Kazakhstan: Russia's Pipe Dreams Fuel Oil Rush on Caspian Sea*, Reuter Textline, May 18, 1995, available in LEXIS, Wires Library, Txttwe File.

potential of the Kazakhstani market may be summarized in the words of Noel Jones, English ambassador to Kazakhstan: "Theoretically it's an open door. Potentially, it's going to be very profitable"⁹⁹ Thus, the third economic condition to the creation of a securities market—the presence of investors who may be willing to invest in Kazakhstani securities—has been satisfied.

D. State Interest

At the beginning of the article, it was stated that the creation of a securities market depends upon the existence of three groups of players in the national economy: issuers of securities, financial intermediaries, and investors. The focus now is on the fourth player—the government—which has the power to create or reject the securities market. From the government's perspective, a securities market raises two issues: First, whether a country needs such a market; and second, even if the country does need such a market, whether it should be regulated by the government. While regulatory issues of the Kazakhstani securities market are discussed in Part III of this article, this part will discuss Kazakhstan's economic interest in a securities market.

The Kazakhstani government appears to favor the creation of a securities market,¹⁰⁰ and, considering the state of affairs in the national economy and all the alternatives to the securities market, such a favorable attitude is justified. Given the national goal of raising capital for economic reforms, Kazakhstan has three major ways to do so: (1) through the direct "sale" of national equity to a few mega-corporations like Chevron;¹⁰¹ (2) through loans from commercial banks; and (3) by introducing a viable securities market. While the correct

99. Davidson, *supra* note 73.

100. The creation of a securities market has been endorsed by President Nasarbaev and, with minor exceptions, by the Kazakhstani Council of Ministers. Berger Interview, *supra* note 36.

101. The direct investments can also be made by investment companies or venture capital firms. However, investments by investment companies presume the existence of a securities market. On the other hand, given the risks of direct investments in the Kazakhstani economy, venture capital firms investing in Kazakhstan either have to be very large (which makes them no different from mega-corporations) or their role in capital raising on the national level would be negligible.

combination of all three methods should give the best results, the exclusion of a securities market from a capital-raising process could seriously damage the economy.

Consider first the direct equity investment by a few multinational corporations. This capital-raising mechanism has a number of major shortcomings. From the Kazakhstani perspective, such direct investment may be perceived by the general population as a "western takeover."¹⁰² Like most of the other former Soviet Republics that were literally enslaved by the Communist Moloch,¹⁰³ Kazakhstan is very sensitive to national independence. Excessive economic power of multinational corporations over the Kazakhstani economy will allow conservative parties to play a nationalist card against the government, thus increasing instability in the country. From the international perspective, Kazakhstan, which has almost no antitrust system, is too susceptible to the monopolization of its economy.¹⁰⁴ As a result, vast oil and gold resources of Kazakhstan easily can be taken over by a powerful concern, which then would be able to affect the world market for these commodities.¹⁰⁵ These problems are less pressing if equity ownership in the Kazakhstani economy is distributed through the securities market, which consists mostly of passive investors.¹⁰⁶

If excessive power of corporate giants raises antitrust and competition concerns, borrowing from commercial banks contains other perils no less detrimental to the economy. As

102. As noted previously, the Law on Foreign Investments does not limit foreign participation in Kazakhstani enterprises. See *supra* notes 86-91 and accompanying text. Therefore, it is possible that an enterprise would be fully controlled by foreigners.

103. Moloch was one of the Babylonian gods whose cult involved human sacrifice.

104. Article 11 of the Civil Code of the Republic of Kazakhstan outlaws anticompetitive practices. See CIVIL CODE, art. 11, translated in THE CIVIL CODE OF KAZAKHSTAN, *supra* note 85, at 29, 36 [hereinafter CIVIL CODE]. However, the law came into effect only in December of 1994, and it is unlikely that Kazakhstan has developed strong antitrust structures.

105. Indeed, Tengiz oilfield, with its daily production capacity of 750,000 barrels, see Higgins, *supra* note 98, can seriously affect the price of oil on the world market. The same is true for Kazakhstani gold mines.

106. For the purposes of this article, I assume that securities markets are not used for corporate takeovers and buyouts. Although in reality this is not true, the issues raised by legislation similar to the United States Williams Act are outside the scope of this paper.

Macey and Miller have stated, "While placing banks in positions of exceptional power over their borrowers may be optimal for banks, it may not be optimal for the rest of society."¹⁰⁷ Since debt holders, as opposed to equity holders, have a fixed claim against a company, they are inimical to any risk-taking by the company even if such risk-taking may benefit the company and ultimately increase the equity.¹⁰⁸ If the debt is raised through the securities markets, the only way bondholders can affect the corporate decision-making process is through restrictive covenants in the indenture. In contrast, an expansion of direct lending by commercial banks as the only means of capital raising gives the banks a dominant position in the corporate governance system.¹⁰⁹ Consequently, the banks may use their dominant power over the corporate governance to prevent companies from undertaking risky projects.¹¹⁰ Given the fact that the Kazakhstani economy is struggling through a transition period, risk-taking is an inherent part of the nation's economic development. In this situation, risk-averse lenders with excessive power over their borrowers can undermine the very process of transition to the market economy.

As follows from a comparison of direct equity investments, commercial lending and a securities market, the securities market appears to be the most robust and advantageous form of capital raising. It generally does not raise antitrust concerns and does not lead to the allocative inefficiency of corporate governance. Therefore, there is no reason that Kazakhstan should forego this very effective capital-raising mechanism.

In addition to the economic benefits associated with a securities market, the market has an ability to promote social policies brought into existence by the privatization of the Kazakhstani economy. The creation of share ownership has been designed to introduce a new capitalist culture to the general population of the country.¹¹¹ According to Max Weber,

107. Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 96 (1995).

108. See *id.*

109. See *id.* Germany and Japan are examples of such a system. See *id.*

110. See *id.*

111. See, e.g., ROMAN FRYDMAN & ANDRZEJ RAPACZYNSKI, *PRIVATIZATION IN EASTERN EUROPE: IS THE STATE WITHERING AWAY?* 10 (1994). Frydman and Rapaczynski note: "[T]he privatization process in Eastern Europe . . . is not a

the spirit of capitalism "is identical with the pursuit of profit, and forever *renewed* profit, by means of continuous, rational, capitalist enterprise."¹¹² Applying this definition to shareowners, Saunders and Harris suggested that shareholders who are newly converted to capitalism must realize two things.¹¹³ On the one hand, they should understand that, unlike regular savings, shares are not risk-free investments.¹¹⁴ On the other hand, shareholding should not be perceived as a kind of gambling that can bring dramatic gains or tragic losses.¹¹⁵ Only by realizing both aspects of share ownership can a population develop a real capitalist spirit and become "investors" rather than "savers" or "gamblers."

Analyzing the British experience in privatization, Saunders and Harris concluded that privatization attracted "gamblers" and "savers" as much as "investors."¹¹⁶ Moreover, the Confederation of British Industry (CBI) survey found that "many shareholders [of privatized British enterprises] still have little experience of how to trade in shares. Asked where they would seek guidance on where to buy shares, 54% could not answer."¹¹⁷ Thus, Saunders and Harris concluded that privatization itself does not create "capitalist enterprising individuals," rather, "[t]he inspirational dream of creating a nation of shareowners has in part been realized, but nobody noticed any difference. Sociologically, the great privatization crusade has turned out to be much ado about nothing."¹¹⁸

If privatization in Great Britain, a country with highly developed capitalist institutions, did little to develop a sense of capitalism in the general population, not much more can be expected from the general population of Kazakhstan, which was taught for generations to live up to socialist standards.

simple transfer of ownership from the state to private individuals. It is rather a process by which the very institution of property, in the sense in which lawyers and economists employ the term, is reintroduced into East European societies." *Id.*

112. MAX WEBER, *THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM* 17 (Talcott Parsons trans., Harper Collins Academic 1991) (1930).

113. PETER SAUNDERS & COLIN HARRIS, *PRIVATIZATION AND POPULAR CAPITALISM* 154 (1994).

114. *See id.*

115. *See id.*

116. *See id.* at 155.

117. *Id.* at 156 (citing G. Oldham, *TAURUS and the Private Shareholder*, 11 *ECON. AFF.* 14-20 (1990)).

118. *Id.* at 162.

The majority of the Kazakh population can probably be categorized as "savers," whose distrust in rapidly devaluating money prompted their decision to invest in shares of privatized enterprises.¹¹⁹ There is certainly a group of "gamblers," for gamblers exist in any society. But most definitely, the number of real "investors" in Kazakhstani population is negligible.

Under such circumstances, the major goal of privatization—transition to a market economy—cannot be achieved without developing in the general population a capitalist spirit and understanding of values that come along with share ownership. In turn, the task of educating the population about capitalism and a market economy can be fulfilled by the introduction of securities markets, where market forces transform the meaningless price tags attached to the state-distributed vouchers into shares that have true market value. Thus, the social success of privatization is closely tied to the creation of a securities market. From that perspective, Kazakhstan's dilemma is not whether to have or not to have a securities market; rather, Kazakhstan's dilemma is whether to regulate securities trading, and if so, to what extent so that the regulation will successfully jump-start a viable securities market.

III. LEGAL ASPECTS OF KAZAKHSTANI "SECURITIZATION"

A. *The Need for Securities Regulation in Kazakhstan*

As Part II of this article indicates, Kazakhstan has all the prerequisites of an emerging securities market and, most importantly, has a large float of stocks created in the course of a comprehensive privatization program. All of this means that Kazakhstan already has primitive securities trading, which will only develop further with the progress of the privatization program. In this situation, the Kazakhstani government can either permit such a market to develop freely or it can impose a set of regulations on the emerging securities industry. By adopting the Securities Decree,¹²⁰ Kazakhstan has chosen a regulatory approach to the securities market. It appears that a

119. As Deputy Prime-Minister Karibzhanov succinctly put it when explaining the desire of the general population of Kazakhstan to invest their savings in something tangible: "Even though prices may change, a bottle of vodka will always be worth a bottle of vodka." Kynge, *supra* note 28.

120. See *infra* Part III.B.

comprehensive regulation of the securities market is the only way to assure its proper functioning.

Some have suggested that securities markets in the former communist countries should develop freely, without enacting inhibiting regulation in the first instance.¹²¹ This argument is supported by the free marketeers of the Chicago School of Economics.¹²² According to their views, "if companies publish misleading corporate information, that is a sign that there is little demand for accurate information and that regulatory requirements are unnecessary"¹²³ If, on the other hand, there is a strong demand for accurate information, companies will compete with each other to provide as much accurate information as possible for investors.¹²⁴ This notion, however, does not explain why the recurrence of fraudulent practices and market manipulation is so frequent in the securities industry. It also conflicts with the basic premises of securities laws that:

[S]ecurities are inherently "intricate merchandise"; that the peculiar complexities of the securities markets are beyond the common experience or understanding of most public investors; and that a special regulatory agency is needed to provide protection for investors and the public interest.¹²⁵

Thus, world experience shows that securities regulation is necessary in order to prevent abuses and foster markets that merit and retain investor confidence.¹²⁶

In the context of emerging markets in general and Kazakhstan in particular, the market-regulating-market theory is even less workable than in the developed securities markets. The Kazakhstani market, which has not yet developed traditions of disclosure, can hardly be described as an efficient

121. See William J. Williams, Jr., *Securities Regulation in Emerging Capital Markets*, in *INTERNATIONAL SECURITIES MARKETS* 1991, at 213, 216 (PLI Corp. L. & Practice Course Handbook Series No. 743, 1991).

122. See NORMAN S. POSER, *INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS* § 1.2, at 5 (1991).

123. *Id.*

124. See *id.*

125. *Id.* at 6 (quoting *Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. 72 (1987) (summary statement of Milton H. Cohen, Partner, Schiff, Hardin & Waite)).

126. See *id.*

market. Moreover, the general public in Kazakhstan lacks an investment culture to determine what information is necessary to assess the price of a stock. Under such circumstances, newly created joint-stock companies have every incentive to draw a rosy picture of their conditions and to omit all negative information, knowing that the investing public will never be able to discover the truth. As a result, the general public, both domestic and foreign, will abandon the market, leaving it to a few big players who have the power to retrieve all necessary information from the companies. The exclusion of the general public—namely, foreign investors—from the securities market may reduce the flow of capital to Kazakhstani enterprises and eventually slow down the development of the Kazakhstani economy.

In addition to the existence of fraudulent practices of misrepresentation and nondisclosure, an unregulated securities market creates ample opportunities for market manipulation by industry professionals who possess a superior knowledge of the market. The U.S. securities market as it existed before the enactment of federal securities laws is a good example of what might happen in the absence of government regulation of the industry.¹²⁷

In the United States in the nineteenth century, a substantial portion of the public was not accustomed to investing in shares of stock¹²⁸ and the issuers of securities did not have large capitalization.¹²⁹ Under such circumstances, the market was dominated by the pools of speculators known as "bulls" and "bears."¹³⁰ Bears sold stocks short, hoping that the market price would go down, whereas bulls tried to "corner" the stock in order to force the bears to buy this stock from the bulls at a higher price.¹³¹ In order to achieve their goals, market speculators used all kinds of deceit to assure that the com-

127. For an account of manipulative practices by the U.S. securities industry before the enactment of federal securities laws, see NORMAN S. POSER, *BROKER-DEALER LAW AND REGULATION: PRIVATE RIGHTS OF ACTION* § 3.5.1, at 335-44 (1995).

128. *See id.* at 336 & n.3 (citing VINCENT CAROSSO, *INVESTMENT BANKING IN AMERICA* 14-16 (1970)).

129. *See id.* at 336.

130. *Id.*

131. *See id.*

peting pool was unaware of the operation.¹³² When the twentieth century and World War I brought an inexperienced general public into the market, bears and bulls had easy prey for their machinations.¹³³ The general public was cheated out of its money through the use of various devices that created a "price mirage," which lured outsiders into the market to their detriment.¹³⁴ Such devices included wash sales (when a manipulator gave an order to buy stock to one broker and an order to sell stock at the same time to another broker), matched sales (when a manipulator traded with an accomplice for the purpose of creating an appearance of market activity), and injection of false information into the market.¹³⁵

All these manipulative practices existed, despite the fact that spreading false information was considered a fraud under common law;¹³⁶ wash sales were grounds for expulsion from the New York Stock Exchange¹³⁷ as well as criminal prosecution under the New York anti-fraud statute.¹³⁸ It took the U.S. Congress' enactment of sections 9(a) and 10(b) of the Securities Exchange Act of 1934¹³⁹ to effectively fight these activities practiced by "prominent businessmen and national figures of both political parties."¹⁴⁰

With respect to opportunities to manipulate the market, the situation in Kazakhstan is even worse than that of the United States at the end of the nineteenth and the beginning of the twentieth centuries. Unlike the United States, where securities markets had arisen out of an already existing capitalist system, Kazakhstan has artificially introduced the concepts of capitalism and free market into the economy. Further-

132. *See id.*

133. *See id.* at 337.

134. *Id.* at 338.

135. *See id.* at 339-40.

136. *See, e.g.,* Bedford v. Bagshaw, 157 Eng. Rep. 951 (Ex. 1859) (awarding damages for false representations to the London Stock Exchange); People v. Federated Radio Corp., 244 N.Y. 33, 154 N.E. 655 (1926) (criminal prosecution for "fraudulent practice" of issuing worthless securities through misleading advertising).

137. *See* POSER, *supra* note 127, § 3.5.1, at 343 (quoting JOHN J. DILLON, HIND-SIGHTS OR LOOKING BACKWARD AT SWINDLES 62 (1911)).

138. *See* People v. Rice, 221 A.D. 443, 223 N.Y.S. 566 (1st Dep't 1927).

139. 15 U.S.C. §§ 78i(a), 78j(b) (1994).

140. POSER, *supra* note 127, § 3.5.2, at 344 (quoting CAROSSO, *supra* note 128, at 324-25).

more, the Kazakhstani securities industry does not have any system of self-regulation. Finally, the Kazakhstani securities industry, unlike its American predecessor, does not have to reinvent the wheel and can use the manipulative devices developed to the highest sophistication by others. As the experience shows, the only way Kazakhstan may be able to limit market manipulation and other fraudulent practices is through laws that provide for vigorous and effective regulation of the securities market.

The argument for regulation of the securities market is also supported by the experience of other developing countries that have introduced securities regulation into their economies. For instance, in Brazil, where the securities regulation has been designed to develop and build the markets, stock prices rose by 139% immediately after the enactment of the Brazilian securities law.¹⁴¹ As Professor Poser noted, "Brazilian investors and financial firms regarded the statute as a crucial positive factor, since it indicated a decision by the government to aid in the development of the markets."¹⁴² If prior experience is any indication, the enactment of securities regulation in Kazakhstan should also boost the market and increase the confidence of market participants.

In the examination of Kazakhstani securities laws, it must always be noted that despite the apparent similarities in the structure of securities regulation in the former communist countries and the Western world, securities regulation in the latter pursues somewhat different goals. In such countries as the United States and England, government regulation of securities traditionally has been adopted in response to abuses that had occurred in already-existing markets, and has been amended from time to time to meet the demands of a changing market. As some commentators noted, in Western economies "the regulatory activity of the government does not follow some abstract and predetermined rules, but is basically reactive to the situation in the market, both in terms of the content of regulation and the process by which they are promulgated."¹⁴³ Thus, traditional securities regulation can be charac-

141. See Poser, *supra* note 41, at 1292.

142. *Id.*

143. FRYDMAN & RAPACZYNSKI, *supra* note 111, at 172.

terized as responsive, for it follows and responds to market trends.

Securities regulation in Kazakhstan and other former communist countries is being developed for the purpose of creating an orderly securities market out of chaotic trading in securities. Unlike "responsive" securities regulation, as it exists in the United States and other traditional centers of the securities industry, the governments of former communist countries have to anticipate the market in order to move it in the right direction by legislative and regulatory means. This anticipatory character of securities regulation certainly affects its underlying philosophy.

Even though securities regulation in Kazakhstan is largely patterned after the U.S. securities laws, the process of enacting regulation should be anything but a mere copy of the U.S. regulatory scheme. Many provisions of the U.S. securities laws can be used in the Kazakhstani regulatory scheme, but only because these provisions target the same abuses that can be expected on the Kazakhstani market. The philosophical difference in the regulatory schemes in the United States and Kazakhstan can be seen in the rigidity of regulation. For safety reasons, anticipatory regulation is always stricter than responsive regulation. Responsive regulation, which has the benefit of empirical knowledge of the market, may exempt certain economic activities from its purview. In contrast, anticipatory regulation, which, in a way, is a shot in the dark, must try to encompass as many activities as possible just to assure that nothing is omitted.

This difference in philosophy is clearly seen in the following comparison of U.S. securities laws and the Kazakhstani regulatory scheme. Securities regulation in Kazakhstan has few, if any, exemptions. The discussion of the Investment Company Law also shows another aspect of the difference between responsive and anticipatory securities regulation. When comparing the U.S. regulatory scheme, which may be used as an example of responsive regulation, with anticipatory securities regulation in Kazakhstan, it appears that the latter tends to impose more substantive restrictions, in addition to the disclosure requirements.¹⁴⁴

144. See discussion *infra* Part III.B.2, III.C.

Due to the anticipatory nature of the regulation, any omissions that can be found in the Kazakhstani scheme may prove particularly damaging. U.S. securities regulators can justify non-inclusion of certain restrictions and liabilities in the securities laws on the basis of empirical studies of the market. In contrast, Kazakhstani securities regulators labor under a complete uncertainty as to the future of the Kazakhstani securities market. Moreover, as described earlier, the ability of the Kazakhstani securities industry to promptly develop an "expertise" in securities fraud eliminates the possibility of a "wait and see" approach to securities regulation. To that end, there is no reason for Kazakhstan not to include something that has proven to be workable in other securities markets, where the goal of the Kazakhstani regulation is to anticipate and trigger the creation of the market.

This is not to say that Kazakhstani regulators should include all provisions of the U.S. securities laws that have proven to be workable in the U.S. market, however complex and technical they may be. It will be years before the Kazakhstani market will be able to match, even remotely, the scale and sophistication of the U.S. market. As Professor Poser noted in his study of Brazilian securities regulation, which regulation was enacted to develop the capital markets in Brazil, "[t]he regulatory measures, if too far ahead of generally accepted standards, may inhibit rather than further market development."¹⁴⁵ Therefore, overly zealous regulation will have the counter-effect of scaring off industry professionals, and will ultimately destroy the market even before it is created. This is another aspect that distinguishes an anticipatory regulation from a responsive one: the proper balance between investor protection and favorable market conditions should be anticipated rather than deduced from market studies.

This paper does not attempt to suggest a clear-cut solution for striking the right balance in anticipatory regulation, partly because there may not be one. Rather, it tries to survey the Kazakhstani regulatory scheme in comparison to the U.S. securities regulation scheme. It is hoped that this survey will be useful in helping us decide how close the drafters of Kazakhstani securities laws come to the ideal anticipatory

145. Poser, *supra* note 41, at 1294.

regulation, which would transform unorganized securities trading into an orderly and attractive securities market.

B. The Kazakhstan Securities Decree and Its Enforcement

On April 21, 1995, the President of the Republic of Kazakhstan issued the Decree on Securities and Stock Exchanges (the Decree or Securities Decree).¹⁴⁶ This Decree is now the highest law on securities in Kazakhstan and, given the recent parliamentary crisis in the republic,¹⁴⁷ political observers do not anticipate a parliamentary law on securities in the near future.¹⁴⁸ The Decree was drafted with the assistance of a team of U.S. attorneys hired for this purpose by US AID.¹⁴⁹ Consequently, the Decree is founded on the principles underlying the U.S. securities laws, adjusted for local conditions. The resemblance to U.S. securities laws facilitates the discussion of the Decree and its comparison to the U.S. scheme of securities regulation.

Given the main goal of Kazakhstani securities regulation—namely, to develop an orderly securities market out of the existing primitive securities trading—a number of areas covered by the Decree merit special attention. Regulation of companies through the disclosure and registration requirements helps increase the efficiency of the Kazakhstani market. In addition, it helps reduce opportunities for the over-issue and counterfeiting of securities through the establishment of a national securities registry. Regulation of industry profession-

146. Decree of the Republic of Kazakhstan President Having the Force of Law on Securities and Stock-Exchanges (Apr. 21, 1995) [hereinafter Securities Decree] (official English text on file with the *Brooklyn Journal of International Law*).

147. In March 1995, President Nasarbaev dissolved the Parliament of Kazakhstan. See *supra* note 96. However, in late 1995, the president issued an executive decree reconvening Parliament. See Ukaz Prezidenta Respubliki Kazakstan imeyushi silu Zakona O Parlamente Respubliki Kazakstan I Statuse Ego Deputatov [Decree of the President of Kazakhstan Having the Force of Law Concerning the Parliament of the Republic of Kazakhstan and the Status of Its Members] (Oct. 16, 1995). As of early 1997, the Parliament has not enacted any new securities laws, and thus the Securities Decree remains in full effect.

148. See James B. Varanese, *Kazakh President Issues a Comprehensive Decree on the Securities Market*, RUSS. & COMMONWEALTH BUS. L. REP., May 24, 1995, at 3.

149. Berger Interview, *supra* note 36. The project was called US AID, Capital Markets Consortium, Republic of Kazakhstan, Securities Commission Policy Team. *Id.*

als is designed to assure their honesty and fitness for dealing in securities. Finally, both governmental and private enforcement of the securities laws in Kazakhstan is necessary to give bite to its securities regulation. These areas are discussed in greater detail, following a discussion of the scope of the Kazakhstani Securities Decree.

1. Scope of the Decree

As is clear from its title, the Decree regulates transactions in securities. Article 5 of the Decree defines securities as stocks, bonds, bank certificates, *veksels* (bills of exchange), and other types of securities so defined by the decisions of the National Commission on Securities.¹⁵⁰ The definition of "security" under the Decree differs from those under the U.S. securities laws. Generally, short-term notes are excluded from the definition of security under U.S. securities laws.¹⁵¹ In contrast, the Decree includes short-term debt instruments, such as bills of exchange, in the definition of security.¹⁵² The broader definition of security reflects local realities of the market. Bills of exchange are currently in use in Kazakhstan, and their use is growing because these instruments secure the underlying assets of privatized enterprises.¹⁵³ Due to their extensive use in privatization, bills of exchange are actively traded on the stock market,¹⁵⁴ and therefore are included in the definition of security.

However, what is missing from the definition of security under the Decree are so-called investment contracts.¹⁵⁵ As interpreted in a landmark U.S. Supreme Court decision, *SEC*

150. Securities Decree, *supra* note 146, art. 5.

151. For instance, the Securities Act of 1933 exempts from registration requirements any notes, drafts or bills of exchange which have a maturity of fewer than nine months. *See* Securities Act of 1933 § 3(a)(3), 15 U.S.C. § 77c(a)(3) (1994). Similarly, § 3(a)(10) of the Securities Exchange Act of 1934 excludes these instruments from the definition of "security." *See* 15 U.S.C. § 78c(a)(10). Courts in the United States have consistently interpreted the definitions in the two acts as identical. *See, e.g.,* *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990) (citing *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975)).

152. Securities Decree, *supra* note 146, art. 5.

153. *See* Vojack Memorandum on *Veksels*, *supra* note 39.

154. *See id.*

155. *See* Securities Act of 1933 § 2(1), 15 U.S.C. § 77(b)(1).

v. W.J. Howey Co.,¹⁵⁶ the investment contract that satisfies the statutory definition of a security is a contract or transaction whereby a person invests in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party.¹⁵⁷ The "investment contract" definition of security brings various fraudulent devices within the coverage of securities laws. The need for the inclusion of the "investment contract" definition in securities regulation can be demonstrated in the context of a so-called "Ponzi scheme."¹⁵⁸ While fighting Ponzi schemes by means of regular anti-fraud rules, such as common-law fraud, presents a difficult task because of the sophistication of such schemes and the expertise of their promoters, strict liability for non-registration of a security makes it easier to defeat this type of fraudulent scheme.

The problem with fraudulent devices like Ponzi schemes is especially acute in countries of the former Soviet Union, where the transition to a market economy has brought into existence all kinds of swindlers eager to defraud inexperienced investors.¹⁵⁹ The inclusion of "investment contract" in the definition of "security" in article 5 of the Decree certainly would help to prevent fraud on the Kazakhstani securities market. Even though the National Securities Commission (NSC) is empowered by article 5 to expand the definition of "security" under the Decree, a direct reference to investment contracts in the Decree itself would facilitate the enforcement efforts of the NSC with respect to these types of securities.

156. 328 U.S. 293 (1946).

157. *Id.* at 301.

158. In a classic Ponzi scheme, named after its inventor Charles Ponzi, new layers of victims enable the swindlers to partially repay previously defrauded customers, and thus allow the system to run for a considerable period of time. For a description of the scheme developed by Ponzi, see *Cunningham v. Brown*, 265 U.S. 1, 7-9 (1924).

159. The most notorious scandal involved the Russian consortium MMM. Investors had been enticed into investing in MMM by fraudulent promises of exorbitant returns; they were ultimately cheated out of their money. See J. Robert Brown, Jr., *Order from Disorder: The Development of the Russian Securities Markets*, 15 U. PA. J. INT'L BUS. L. 509, 512 & n.9 (1995). The MMM scandal, however, is far from the only example. See *id.* at 512.

2. Regulation of Companies

a. Registration

The Decree provides for the registration of securities and disclosure of essential information regarding these securities. Because of these provisions, the ideology of the Decree is the same as that in the U.S. securities laws. As President Franklin D. Roosevelt wrote in his message to Congress, presenting the draft of the Securities Act of 1933:

There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of *caveat emptor*, the further doctrine "let the seller beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.¹⁶⁰

The Decree requires every issuer of securities to register newly issued securities with the NSC and prohibits the sale of unregistered securities.¹⁶¹ Interestingly, the Decree does not exempt any primary distributions from registration. It specifically states that a security must be registered regardless of the type and the amount of an offering.¹⁶² Moreover, the Decree requires any joint-stock company to register its securities within three months from the date of incorporation.¹⁶³ The Decree subjects to registration both private placements to no more than fifty purchasers and public offerings.¹⁶⁴

The concept of universal registration is quite different from the concept contained in the U.S. registration requirements. The Securities Act of 1933 (the Act) and the SEC regu-

160. H.R. REP. NO. 73-85, pt. 1, at 2 (1933) (President's Message to Congress).

161. Securities Decree, *supra* note 146, art. 17, para. 10. The Decree uses the term "emitter" instead of "issuer." However, since the word "issuer" has become a term of art in U.S. securities regulation, and for purposes of convenience, this article will refer to emitters of securities as issuers of securities, and the emission of securities will be referred to as the issuance of securities accordingly.

162. *Id.* para. 1.

163. *Id.* para. 6.

164. *Id.* art. 18.

lations adopted thereunder exempt from registration certain offerings of securities; the exemptions are based on limitations on either the number of purchasers or the amount of the offering. For instance, section 4(2) of the Act states that the registration provisions should not apply to "transactions by an issuer not involving any public offering."¹⁶⁵ As the U.S. Supreme Court explained in *SEC v. Ralston Purina Co.*,¹⁶⁶ this exemption applies to private placements of securities where the purchasers of the securities do not need the protection of the registration provisions of the Act.¹⁶⁷ Issuers may use SEC Regulation D, which delineates elements of an offering that will be exempt from the registration requirements of the Act.¹⁶⁸ Finally, SEC Regulation A provides a simplified procedure for the registration of small offerings.¹⁶⁹ Although the Act and the SEC rules provide for a number of other exemptions, they are not as widely used as those mentioned above, and they are most likely inapplicable to the Kazakhstani market.¹⁷⁰

Private placement and limited offering exemptions may come in very handy in Kazakhstan, where many potential issuers are unable to afford the costs of a fully registered public offering. Nevertheless, the drafters of the Decree preferred to globalize the registration requirements. The rationale behind this decision is not hard to find: the Kazakhstani securities market has no background in informational efficiency or full disclosure of essential information. As mentioned above, the Decree is designed to prohibit abuses and fraudulent practices that do not yet exist on the market but that are expected to exist once the market develops. Under the circumstances, the traditions of economic *glasnost* (full and accurate disclosure of information) can be created and developed only through the rigid government enforcement of disclosure requirements, a goal that can be achieved only through universal registration

165. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1994).

166. 346 U.S. 119 (1953).

167. *Id.* at 124-25.

168. 17 C.F.R. §§ 230.501-508 (1996).

169. 17 C.F.R. §§ 230.251-263. Regulation A was adopted under § 3(b) of the Act, which empowers the SEC to exempt from registration requirements certain public offerings with an aggregate amount of no more than US\$5 million. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b).

170. For instance, the intrastate offering exemption of § 3(a)(11), 15 U.S.C. § 77c(a)(11), is certainly inapplicable to a unitary country such as Kazakhstan.

requirements with no loopholes. It is possible that at some later stage in the development of the Kazakhstani securities market such comprehensive registration requirements may adversely affect the expansion of the market, justifying the introduction of exemptions to registration. Presently, however, the task of preventing fraud and manipulation in the securities market at the early stages of its development may justify the rigidity of the Decree.

The Decree delineates the registration procedure for the issuance of securities. The registration statement must be examined and declared effective by the NSC.¹⁷¹ The examination procedure, however, is not designed to determine the "quality" of the new issue. As article 17 further provides, the registration may be denied only if the documents submitted to the NSC do not conform to the requirements of the law.¹⁷² These provisions echo the idea that the "[g]overnment cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit."¹⁷³

After an issuer submits a registration statement, the NSC has thirty days to either approve or deny the registration.¹⁷⁴ The thirty-day limit protects the issuer against bureaucratic inefficiency of the government. Thus, article 17 of the Decree contemplates a two-step registration process comprised of a waiting period and a post-registration period. Article 17 also provides that the issuance of securities may be commenced only after their registration.¹⁷⁵ Article 20 of the Decree allows the issuer to distribute a prospectus only after the registration of securities,¹⁷⁶ and also provides that securities may be sold no earlier than one month after the publication of a prospec-

171. See Securities Decree, *supra* note 146, art. 17, para. 1.

172. *Id.* para. 5. Article 21 further enumerates grounds for denial of registration: (1) violations of existing Kazakhstan law; (2) inaccurate information in a prospectus; (3) failure to notify investors if new material information arises during the issuance, dramatically changing the issuance terms; and (4) the issuing of securities exceeding the amount disclosed in a registration statement. *Id.* art. 21, para. 1.

173. H.R. REP. NO. 73-85, pt. 1, at 2 (1933) (President's Message to Congress).

174. See Securities Decree, *supra* note 146, art. 17, para. 4.

175. *Id.* para. 1.

176. *Id.* art. 20, para. 1.

tus.¹⁷⁷

Thus, the statutory scheme contemplates that securities may be sold no earlier than one month after the effectiveness of the registration statement (assuming that the prospectus is published at the moment of registration). However, it is unclear from the Decree whether or not the issuers may make oral offers to purchasers during the waiting period. In comparison, section 5(a)(1) of the Securities Act does not prohibit oral offers during the waiting period.¹⁷⁸ Also, in recognition of the fact that the prices of securities change rapidly and cannot be known in advance, sections 5(b)(1)¹⁷⁹ and 10(b)¹⁸⁰ of the Act allow issuers to deliver a so-called preliminary prospectus, which must conform to the requirements of SEC Rule 430.¹⁸¹ This complex scheme of the U.S. Securities Act is not contemplated by the Decree. Given the "draconian nature" of the Decree as a whole, we must presume that *any* communication with prospective purchasers of a security during the waiting period is illegal. This outcome is probably justified at the early stages of the development of a securities market when fraudulent practices, rather than convenience of the issuers, should be the main concern of regulators.

What is more troublesome, however, is that the Decree does not contemplate any exceptions for underwriters. As defined by section 2(11) of the Securities Act, an underwriter is a person "who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . ."¹⁸² Since the underwriter necessarily commits itself to purchase securities prior to the filing of a registration statement, section 2(3) of the Act excludes preliminary negotiations between an issuer and an underwriter from the definition of "sale" of securities.¹⁸³ The Decree has no similar exclusion. Moreover, the Decree does not even contain

177. *Id.* para. 7. The one-month period, adopted from U.S. securities laws, is apparently designed to prevent "[h]igh-pressure salesmanship . . . before the investing public [can] digest the information demanded." H.R. REP. NO. 73-85, pt. 1, at 3 (1933).

178. Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1) (1994).

179. 15 U.S.C. § 77e(b)(1).

180. 15 U.S.C. § 77j(b).

181. 17 C.F.R. § 230.430 (1996).

182. 15 U.S.C. § 77b(11).

183. 15 U.S.C. § 77b(3).

a definition of "underwriter." Therefore, any underwriting activity may technically violate the Decree's prohibition to sell securities prior to the filing of a prospectus and the issuers may have to conduct offerings of securities by themselves. The exclusion of underwriting professionals, such as investment bankers, from the issuance process makes the process very inefficient and may adversely affect the development of the securities market in Kazakhstan. Kazakhstani lawmakers should rethink their position with respect to securities underwriting and amend the Decree accordingly.

An offering must be concluded within one year after the registration statement has been approved by the NSC.¹⁸⁴ This provision limits the possibility of shelf registration similar to that provided by the SEC "shelf-registration" Rule 415.¹⁸⁵ Given the rigid registration requirements of the Decree, the one-year time limitation makes sense. A closer look at SEC Rule 415 shows that shelf registration is available only for those issuers who have established their reputation on the market.¹⁸⁶ In the absence of such "reliable" issuers on the Kazakhstani market, shelf registration would serve no meaningful purpose.

Another important aspect of registration requirements under the Decree is the creation of a national register for new issues. Article 17 of the Decree empowers the NSC to maintain a national register of securities and requires every issue of securities to be included in this register.¹⁸⁷ This provision is designed to prevent counterfeiting and over-issue of securities. Securities—just like any other note, including bank notes—are just pieces of paper that can be forged easily. Although a complete resolution of the problem of counterfeiting is probably impossible, as evidenced by diligent but unsuccessful efforts by

184. See Securities Decree, *supra* note 146, art. 17, para. 6.

185. 17 C.F.R. § 230.415. Rule 415, subject to numerous limitations, allows the delayed issuance of securities within two years after the effectiveness of a registration statement. See *id.* § 230.415(a)(2).

186. *Id.* § 230.415(a)(1)(x). Rule 415 allows shelf registration for issuers qualified to issue securities on Form S-3, see *id.* § 239.13, or Form F-3, see *id.* § 239.33, or for issuers who have a long history of public issuance of securities and if information about the issuer is widely available on the market. Kazakhstan does not permit shelf registration, nor does it need it, since there are no well-established issuers in Kazakhstan.

187. Securities Decree, *supra* note 146, art. 17, paras. 9-10.

the U.S. Department of Treasury to fight counterfeiting of dollars, the National Register of securities in Kazakhstan will provide at least some reference point where the authenticity of a securities certificate can be ascertained.

Article 19 of the Decree requires issuers to maintain a registry of its security holders that must reflect changes in beneficial ownership of the securities at any given moment.¹⁸⁸ Moreover, such a registry must be maintained by an independent agency if a joint-stock company has 500 or more shareholders.¹⁸⁹ The problem with this provision is that it does not define the term "independent." Such a loophole may allow the management of the companies to control and manipulate their registries in order to prevent outside investors from participating in the management of a company.¹⁹⁰ Besides, the absence of truly independent registries may allow the management of Kazakhstani companies to over-issue securities, by simply running printing presses. Licensing of such registries by the NSC may provide a solution to the problem.

b. Disclosure

As already mentioned, article 20 of the Decree requires the issuers to provide information about the security in a prospectus.¹⁹¹ The contents of the prospectus are determined by the rules of the NSC.¹⁹² The prospectus must contain an audited financial statement no older than six months, measured from the effective date of the registration statement.¹⁹³ As of 1995, the NSC of Kazakhstan adopted the Interim Regulation on Securities developed by the same group of U.S. securities attorneys that drafted the Decree.¹⁹⁴

188. *Id.* art. 19, para. 1.

189. *Id.*, para. 2.

190. The problem of management taking advantage of similar gaps in the regulatory framework to maintain control over companies has already arisen in Russia. See Brown, *supra* note 159, at 522-23.

191. Securities Decree, *supra* note 146, art. 20, para. 4.

192. See *id.* para. 5.

193. See *id.* para. 3.

194. See Gregory J. Vojack & Farhad Karagusov, *Kazakhstan: New Legal Framework Adopted for Securities Market*, EAST/WEST EXECUTIVE GUIDE, May 1995, at 7, 7-8. Mr. Vojack, of Bracewell & Patterson in Almaty, is a Project Director for the US AID Capital Markets Consortium, Securities Commission Policy Team, in Kazakhstan.

Under the Interim Regulation, the prospectus must contain the following information: name and organizational legal status; name and location of the enterprise's bank; a list of all shareholders who hold more than five percent equity in the enterprise; a list of all officers; three years of financial history; a description of the enterprise's significant assets; authorized fund capital; information on any administrative sanctions; a statement on the enterprise's use of profit; and a statement of the material risks of the investment.¹⁹⁵ Not surprisingly, the Interim Regulation disclosure requirements reiterate in most parts the disclosure requirements of SEC Regulation S-K.¹⁹⁶

The major drawback of a disclosure system in Kazakhstan is the absence of an auditing and accounting system similar to that in the West. The old Soviet system of accounting was founded on principles fundamentally different from those accepted in the West and this difference makes financial disclosures in the Kazakhstani system defective and uninformative. The accounting principles in former Soviet Republics, having arisen in a non-market economy, did not develop out of a need to provide investors with information necessary to make informed investment decisions, but rather to meet the needs of government authorities, particularly tax authorities.¹⁹⁷ The problem with accounting principles has not gone unnoticed, however, and the Ministry of Finance is in the process of adopting international auditing and accounting standards.¹⁹⁸ Furthermore, the presence of such prominent accounting firms as Price Waterhouse, Arthur Anderson, and Coopers & Lybrand in Kazakhstan will probably expedite the process.¹⁹⁹ Therefore, it appears that the problem with the financial disclosure in Kazakhstan is a transient one, which will be cured in the immediate future.

Although the Interim Regulation disclosure requirements are not the last word (even the term "Interim" suggests that they are not) on the disclosure of material information about securities, it is a good start toward creating an efficient securities market. There is a view to the contrary, however. On the

195. *See id.* at 8.

196. *See generally* 17 C.F.R. § 229.10-915 (1996).

197. *See Brown, supra* note 159, at 539.

198. *See Vojack & Karagusov, supra* note 194, at 8.

199. *See supra* text accompanying note 73.

basis of his studies of the Russian securities market, Professor Brown has suggested that no legal reform will bring order to the markets.²⁰⁰ As an example, Brown uses the public offering by the All-Russian Automobile Alliance (AVVA).²⁰¹ The AVVA prospectus "contained no specific discussion of the use of proceeds, true risks of the investment, the time frame for when automobile production would begin, and the controlling shareholders of the shell company," but was, nevertheless, filed with the Russian Ministry of Finance and was declared effective.²⁰²

The disclosure requirements for the issuance of securities in the Russian Federation are outside the scope of this article; however, as Professor Brown himself admits, the disclosure requirements contained in Russian regulations, especially with respect to financial disclosure, were "inadequate."²⁰³ Assuming that this prospectus were offered in Kazakhstan, and assuming further that the international auditing and accounting principles are already in effect there (which should probably happen in the near future), such a prospectus would have violated, on its face (at least as described by Professor Brown), the Interim Regulation disclosure requirements. Consequently, the NSC could have denied the registration of such securities pursuant to article 21 of the Decree as containing imprecise information.²⁰⁴ Thus, it appears that detailed and vigorously enforced disclosure requirements can and will assure that the investing public receive all necessary information about the issuer and about the security being issued. Although the Kazakhstani Interim Regulation may not prevent all disclosure tricks used by unscrupulous issuers, the persistent improvement and specificity of disclosure requirements in Kazakhstan may bring order to the market of primary distributions.

3. Regulation of the Industry and Government Oversight

One of the major achievements of the Decree is the establishment of the National Securities Commission (NSC).²⁰⁵

200. Brown, *supra* note 159, at 556-57.

201. *Id.* at 540.

202. *Id.*

203. *Id.* at 539.

204. Securities Decree, *supra* note 146, art. 21, para. 1.

205. *Id.* arts. 9-16.

"What is unique about Kazakhstan's new NSC is that it is the first time that one of the former [Soviet] republics has centralized the regulation of the securities market into a single agency with a staff."²⁰⁶ The NSC, like the U.S. Securities and Exchange Commission (SEC), consists of a Chairman and four members who are nominated by the Prime-Minister and appointed by the President for five-year terms.²⁰⁷ To prevent possible conflicts of interest, NSC Commissioners are prohibited from participating in any other activities except for academic or teaching activities.²⁰⁸ The NSC is empowered to create regional departments to facilitate the enforcement of the securities laws and oversight of the industry.²⁰⁹

The NSC enjoys broad regulatory powers enumerated in article 12 of the Decree. Under article 12, the NSC develops and presents to the Parliament any legislation on securities, conducts registration of newly issued securities, registers foreign securities for trading on the territory of Kazakhstan, and keeps the national register of securities.²¹⁰ The Commission also oversees industry professionals by issuing broker-dealer and other professional licenses, establishing necessary qualifications for securities professionals, and controlling the industry through periodic reports by industry members.²¹¹ In that respect, the powers of the NSC are very much like those of the SEC.²¹²

The powers of the NSC in the enforcement area are, however, more limited than those of the SEC. The NSC has a right to conduct investigations after which it may either bring a civil suit against violators of the securities laws or report the violation to the prosecutorial organs of Kazakhstan.²¹³ Yet the NSC has no prosecutorial power under the Decree. Although the licensing and registration authority of the Commission

206. Vojack & Karagusov, *supra* note 194, at 7; see Securities Decree, *supra* note 146, art. 9.

207. See Securities Decree, *supra* note 146, art. 14, paras. 1, 3.

208. See *id.* para. 5. This provision is very important because the first Commissioners were recruited, in part, from the industry. Berger Interview, *supra* note 36.

209. See Securities Decree, *supra* note 146, art. 16.

210. *Id.* art. 12.

211. See *id.*

212. See, e.g., 15 U.S.C. § 77f(a) (1994) (filing of registration statements with the SEC); 15 U.S.C. § 78o (registration of brokers and dealers with the SEC).

213. See Securities Decree, *supra* note 146, art. 12.

implies the power to deny, suspend or revoke the license of any industry member or deny the registration of securities,²¹⁴ this is probably all the Commission can do to fight the violations of the securities laws. Unlike the SEC's authority to assess monetary penalties,²¹⁵ the Decree does not provide the NSC with the power to impose such penalties for violations of the securities laws. Nor does it give the NSC cease-and-desist authority—a powerful enforcement tool used by the SEC pursuant to recent amendments to the securities acts.²¹⁶ Without the power to punish violators of the Kazakhstani securities regulation, the NSC will have to refer every infraction, however small, to the prosecutorial organs or to litigate every violation of the securities laws. For purposes of efficiency and heightened respect for the agency, the Decree should be amended to add these important powers to the NSC enforcement arsenal.

In addition to the creation of the NSC, the Decree provides for a system of self-regulation of the industry.²¹⁷ The system of self-regulation certainly adds efficiency to the enforcement of the securities laws. The self-regulatory organizations (SROs) are most closely involved in the day-to-day running of the market and therefore are best situated to perform the bulk of securities regulation. Even though the SROs can potentially be biased in favor of industry members, proper supervision by the government agency may assure a disinterested position. Expansive self-regulation under governmental supervision is inherent not only in the U.S. securities markets, but also has been adopted in England.²¹⁸ Accordingly, the drafters of the Decree provided some framework for a system of self-regulation in the Kazakhstan securities industry. The system envisioned by the Decree, however, is somewhat different from that of the United States.

214. *See id.* art. 21, para. 1.

215. *See* Securities Law Enforcement Remedies Act of 1990 § 21B, 15 U.S.C. § 78u-2(a) (1994).

216. *See id.* § 8A, 15 U.S.C. § 77h-1; *id.* § 21C, 15 U.S.C. § 78u-3. Cease and desist authority, though a relatively recent empowerment, is believed to enhance the SEC's ability to flexibly tailor remedies to the facts and circumstances of a particular case. *See* S. REP. NO. 101-337, at 3, 20 (1990).

217. Securities Decree, *supra* note 146, art. 27.

218. *See* POSER, *supra* note 122, § 3.1.1, at 83-90 (discussing the Gower Report, *see* L.C.B. GOWER, REVIEW OF INVESTOR PROTECTION (1984), and the British government's "White Paper," *see* DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES IN THE UNITED KINGDOM (1985)).

For purposes of economy of scale and most efficient pricing and liquidity, the drafters of the Decree suggested that Kazakhstan have only one stock exchange.²¹⁹ An over-the-counter market (OTC) apparently was considered unacceptable at this stage. This view was reflected in Chapter 5 of the Decree entitled "Stock Exchange."²²⁰

According to the Decree, a stock exchange formed pursuant to the Decree must be licensed by the NSC²²¹ and formed as a joint-stock company.²²² Further, a stock exchange must have minimum capitalization equal to 10,000 times the minimum wage established in the country at the time of licensing.²²³ The Stock Exchange is governed by a board whose members may not be government officials or the directors of the issuers listed on the stock exchange.²²⁴ Membership in the Stock Exchange is limited to licensed securities professionals and may include foreign persons duly licensed by the NSC.²²⁵

The Decree requires the stock exchange to adopt trading rules and listing requirements, and to maintain and publish a pricing system.²²⁶ Also, pursuant to this chapter of the Decree, the Stock Exchange is required to adopt and enforce regulation of its members,²²⁷ and may impose monetary penalties for the violation of these regulations.²²⁸ It also may suspend or revoke membership of a violator.²²⁹ In addition to the regulation of the Stock Exchange, the Decree envisions the possibility of other self-regulatory organizations. The definitional section of the Decree specifically provides the definition of the "Associations of Professional Participants" (SROs).²³⁰

Although the Decree provides for a framework of self-regulation very similar to that in the United States, one major

219. See *Structure of a Secondary Market*, *supra* note 37.

220. Securities Decree, *supra* note 146, arts. 31-44.

221. *Id.* art. 32, para. 4.

222. *Id.* art. 31, para. 1.

223. See *id.* art. 32, para. 2. As of May 1995, this amount equals US\$2 million. See Vojack & Karagusov, *supra* note 194, at 8.

224. See Securities Decree, *supra* note 146, art. 34, para. 2.

225. See *id.* art. 33, para. 2.

226. *Id.* art. 38, para. 2.

227. See *id.*

228. See *id.*

229. See *id.* art. 32, para. 4; *id.* art. 38, para. 2.

230. *Id.* art. 3.

distinction should be noted. Under section 15(b)(8) of the Securities Exchange Act, every broker-dealer must be registered with a registered securities association.²³¹ The Decree has no requirement that a market professional be a member of one of the SROs in addition to being duly licensed by the NSC.²³² However, the absence of mandatory membership in one of the SROs is not illogical. First, such absence has its precedents in world securities practice. For instance, according to a regulatory scheme envisioned by Professor Gower for the securities industry in England, a broker-dealer would have had a choice of seeking authorization directly from a British government agency or with an SRO recognized by such agency.²³³ Second, the structure of the Kazakhstani market, with only one stock exchange, makes it impossible for a broker-dealer to conduct business without being a member of the Stock Exchange. The problem may arise with the development of an OTC market where broker-dealers are able to transact business outside the Stock Exchange and therefore do not need its membership. However, the development of the OTC market in the Kazakhstani economy at this stage is so unlikely and will cause so many regulatory problems that no SRO will be able to resolve them.²³⁴ Under the circumstances, the drafters of the Decree correctly chose not to overburden an immature Kazakhstani securities industry with economically and legally unnecessary requirements.

4. Private Enforcement of the Securities Laws in Kazakhstan

Proper enforcement of the Kazakhstani securities regulation is crucial for the development of a securities market. As noted before, the Kazakhstani market has to rely, for the most

231. 15 U.S.C. § 78o(b)(8) (1994). Currently the National Association of the Securities Dealers (NASD) is the only registered securities association in the United States.

232. See Securities Decree, *supra* note 146, art. 27.

233. See POSER, *supra* note 122, at 86 (citing GOWER, *supra* note 218, ¶ 2.11).

234. It is much easier to control an auction market (such as a Stock Exchange), which is physically concentrated in one place, than to regulate an OTC market, with its amorphous structure and lack of centralized trading. Even though the OTC market can be made more organized through the introduction of the automated trading system (like NASDAQ), only two countries—the United States and Britain—have such a system, and it would be too ambitious to project the same for Kazakhstan.

part, on foreign institutional investors, because the Kazakhstani economy is not strong enough to raise capital exclusively from domestic sources. In order to attract foreign investors, Kazakhstan has to compete with a few dozen other emerging markets. All economic factors being equal, Kazakhstan may win this competition only if it is able to offer foreign investors a market environment to which they are accustomed. Clearly, a system of enforcement that closely resembles that of the world's leading securities markets will make these institutional investors most comfortable about investing in the Kazakhstani market.

It appears that Kazakhstani laws related to the securities regulation can provide for such a "westernized" enforcement scheme. Certain liabilities and remedies are contained in the Decree itself, while the others can be found in the new Kazakhstan Civil Code (the Code or the Civil Code).²³⁵ The Decree and the Code together provide powerful tools for both administrative and private enforcement of the securities laws. It should be noted, however, that the presence of suitable legislation does not guarantee securities enforcement *à l'Américain*. Unfortunately, there is not sufficient information about the Kazakhstani court system to predict the attitude of the Kazakhstani judiciary toward the enforcement of Kazakhstani securities regulation. This article merely tries to suggest ways in which the Kazakhstani securities enforcement scheme can be adapted to fit the standards of a Western investor.

In a discussion of remedies and liabilities, it is very important to keep in mind that Kazakhstan is a civil law country and all remedies and liabilities are created by statutes. Article 7 of the Civil Code provides grounds for civil rights and duties to arise.²³⁶ Under article 7, civil rights arise partially out of contracts, transactions provided by legislation, and transactions not provided by legislation but not contrary to legislative acts.²³⁷ Civil rights can also arise out of administrative

235. The Civil Code of Kazakhstan was adopted by the Supreme Soviet of Kazakhstan on December 27, 1994. See THE CIVIL CODE OF KAZAKHSTAN, *supra* note 85, at 1. Because of the dissolution of Parliament in 1995, it is unclear whether the old or new Civil Code is now in effect in Kazakhstan. However, the old Code does not mention securities at all. Therefore, I will rely on the new Code in discussing liabilities and remedies.

236. CIVIL CODE, *supra* note 104, art. 7.

237. *Id.* art. 7, para. 2(1).

acts,²³⁸ such as the Securities Decree.²³⁹ Additionally, citizens may effectuate their civil rights through the right to the defense thereof.²⁴⁰ The right of defense may be exercised either through recourse to a government agency in charge or through the assertion of rights in a lawsuit.²⁴¹ In furtherance of his or her right of defense, the damaged party may recover compensatory damages, including consequential damages—in the wording of the Code, “revenues not received which this person would have received under ordinary conditions of turnover if his right had not been violated (lost advantage).”²⁴² Finally, an individual who has sustained losses because of the government agency’s failure to act can recover those losses from the state.²⁴³

Thus, the principle of the right of defense gives a person who has sustained losses as the result of a violation of securities regulations the right to recover compensatory damages and lost opportunity damages through a lawsuit in the courts. In the alternative, a person can recover from the NSC, provided that the NSC failed to enforce properly the securities laws and provided that this failure caused losses to the person. It is clear that the right of defense for violation of securities laws arises out of specific legislative provisions that expressly give an individual such a right. The question remains, however, whether, under the Kazakhstani civil law system, the right of defense may arise out of those provisions of the Decree that do not expressly give a private plaintiff a right to sue but simply make unlawful certain activities that have injured the plaintiff.

In common law systems, the courts have historically enjoyed law-creating powers such as finding an implied right of action where the statute is otherwise silent on the subject.²⁴⁴ In the context of securities laws, the U.S. courts have found an

238. See *id.* art. 7, para. 2(2).

239. Securities Decree, *supra* note 146.

240. See CIVIL CODE, *supra* note 104, art. 8(1).

241. See *id.* art. 9(2). Recourse to an agency does not preclude the party from bringing a lawsuit in court. See *id.*

242. *Id.* art. 9(4), para. 2.

243. See *id.* art. 9(5).

244. See Christopher A. Ford, *Judicial Discretion in International Jurisprudence: Article 38(1)(c) and “General Principles of Law,”* 5 DUKE J. COMP. & INT’L L. 35, 54-55 (1994).

implied private right of action under section 10(b) of the Securities Exchange Act.²⁴⁵ However, such an implied right of action does not necessarily exist in civil law systems.²⁴⁶ It is difficult to predict whether Kazakhstani courts will adopt implied private rights of action for violations of the securities laws, but, as stated above, the more Americanized system of securities enforcement may give the Kazakhstani market a competitive edge among other emerging markets.²⁴⁷ Therefore, for purposes of this article, all of the provisions that may give rise to liability are discussed.

Article 17 of the Decree provides that the issuance of unregistered securities is per se illegal and that the money earned as a result of an unregistered issue shall be confiscated and returned to the purchasers of unregistered securities.²⁴⁸ In other words, the Decree gives the purchasers of unregistered securities standing to sue the issuer for rescission, a remedy similar to that contained in section 12(1) of the Securities Act of 1933.²⁴⁹ This provision of the Decree, on its face, imposes strict liability on an issuer who has sold its securities in violation of the registration requirements of the Decree.

Article 24 of the Decree expressly imposes liability on an issuer for false and misleading, untrue or incomplete statements in a prospectus and for any other false and misleading information with respect to the financial and economic activities of the issuer.²⁵⁰ This article closely resembles section

245. *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

246. For instance, the European Court of Justice implied a private right of action under the Treaty Establishing the European Economic Community (EEC Treaty), giving a direct effect to the Treaty where the Treaty itself did not provide for such a private right of action. *See* Case 26/62, *Van Gend & Loos v. Nederlandse Administratie der Belastingen* [Netherlands Inland Revenue Administration], 1963 E.C.R. 1, [1963] 2 C.M.L.R. 105. However, this decision was a novelty that enraged some Member States of the European Community.

The opinion of Advocate General Karl Roemer, while not adopted by the court, represents the prevailing attitude in civil law countries toward implied private rights of action. Mr. Roemer pointed out that the EEC Treaty imposes obligations only on Member States, and should not give rise to a private right of action, since such an action is not provided for under the national laws of some Member States. *See id.* at 21, [1963] 2 C.M.L.R. at 115.

247. *See supra* introductory paragraph to Part III.B.4.

248. Securities Decree, *supra* note 146, art. 17, para. 10.

249. Securities Act of 1933 § 12(1), 15 U.S.C. § 77l (1994).

250. Securities Decree, *supra* note 146, art. 24, para. 1.

12(2) of the Securities Act of 1933, which gives an express right of action for false and misleading statements in connection with the offer and sale of securities.²⁵¹ Under article 24, the issuer is liable for damages to an investor who sustained a loss as a result of misleading statements made by the issuer.²⁵²

It appears that article 24, on its face, is a negligence statute and does not require a proof of scienter.²⁵³ Indeed, in U.S. securities jurisprudence, the scienter requirement has been found only under those provisions that speak "so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing . . ."²⁵⁴ By contrast, article 24 gives a right of action not only for untrue statements, but also for imprecise and incomplete statements.²⁵⁵ In other words, article 24 contemplates liability for innocent omissions as well as for intentional misstatements.²⁵⁶ Finally, the purchaser of a security sold by means of misrepresentation can recover damages to the fullest extent provided by the law.²⁵⁷ Going back to article 9(4) of the Civil Code, this probably means that there is a possibility of recovering compensatory damages and benefit-of-the-bargain damages.²⁵⁸

Article 24 also contains an anti-waiver provision.²⁵⁹ Like section 14 of the Securities Act,²⁶⁰ article 24 makes void any agreement that tends to limit investors' rights under the anti-

251. 15 U.S.C. § 77l(2).

252. Securities Decree, *supra* note 146, art. 24, para. 1.

253. *Id.*

254. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976).

255. Securities Decree, *supra* note 146, art. 24, para. 1.

256. Article 24 states in pertinent part: "If . . . information about an [issuer's] financial-economic activity contains intentionally false, inaccurate or incomplete data that have detrimentally affected investors, the [issuer] shall bear full financial responsibility for damages incurred upon securities-holders." *Id.* art. 24, para. 1. Under the rules of statutory interpretation, the word "intentionally" modifies *only* the word "false," and does not modify "inaccurate" or "incomplete." Thus, a company that negligently issues inaccurate or incomplete information to security holders could potentially be liable under the Securities Decree. This interpretation of the English text is supported by the wording of the official Russian text of the Securities Decree.

257. *See id.*

258. CIVIL CODE, *supra* note 104, art. 9(4); *see supra* note 242 and accompanying text.

259. Securities Decree, *supra* note 146, art. 24, para. 2.

260. Securities Act of 1933 § 14, 15 U.S.C. § 77n (1994).

cle.²⁶¹ The anti-waiver provision is especially important because of the lack of experience of Kazakhstani investors. This provision guarantees that an inexperienced investor will not be coerced into inadvertently giving away his or her rights under the Decree. However, unlike section 14, which applies to the entire statute, the anti-waiver provision in article 24 applies only to liability under that article. All other provisions of the Decree thus appear to be waivable, by negative implication. To avoid this result, the anti-waiver provision should be moved to a separate section applicable to the whole Decree.

Unfortunately, article 24 has very limited force since it imposes liability only on the issuer.²⁶² This liability may, however, be extended through article 20 of the Decree, which imposes upon the signatories of the prospectus responsibility for false and misleading statements in a prospectus.²⁶³ This provision has its analog in the U.S. securities laws and is in a way a hybrid of sections 12 and 11 of the Securities Act. Like section 12(2) of the Securities Act,²⁶⁴ article 20 deals with misleading statements in a prospectus. In other aspects, article 20 is similar to section 11(a)(1) of the U.S. Securities Act which imposes liability for misleading and untrue statements in a registration statement on every person who signed the registration statement and on some other categories of offering participants.²⁶⁵ Since the Decree does not contemplate any exemptions from registration, this approach is reasonable because a prospectus and registration statement are likely signed by the same persons. The major difference, however, is in the wording of section 11 and article 20. Section 11 expressly gives an injured private party a cause of action for misleading statements.²⁶⁶ In contrast, article 20 merely states that signatories to a prospectus are responsible for false and misleading statements in it.²⁶⁷ Although article 20 does not expressly provide for a private cause of action, such an action can be found if article 20 is read in conjunction with articles 7, 8 and 9 of the

261. Securities Decree, *supra* note 146, art. 24, para. 2.

262. *Id.*

263. *Id.* art. 20, para. 6.

264. 15 U.S.C. § 77l(2).

265. *Id.* § 77k(a)(1).

266. *Id.* § 77k(a).

267. Securities Decree, *supra* note 146, art. 20, para. 6.

Civil Code.²⁶⁸ A combined reading demonstrates that article 20 gives rise to civil rights and duties that can be effectuated through the right of defense—the right exercisable in part by bringing a lawsuit for damages. The question arises, then, of the elements of such possible cause of action. Since the Decree is patterned after the U.S. securities laws, it is not surprising that the cause of action under article 20 will closely resemble the cause of action under section 11 of the Securities Act.

It appears that the knowledge of truth by a purchaser at the time of purchase is a defense to article 20 liability, as it is under section 11 of the Securities Act.²⁶⁹ Although the Decree, on its face, is silent as to the knowledge of truth, article 8(4) of the Civil Code imposes a duty of good faith and reasonableness of actions on the participants in civil legal relations.²⁷⁰ Thus, at least arguably, an action by a purchaser of securities for false and misleading statements in a prospectus would be barred if the purchaser knew the truth about the securities, despite the misleading statements in the prospectus.

Another substantial aspect in which article 20 differs from section 11 is that unlike section 11, article 20 does not impose responsibility on anyone other than the signatories to a prospectus. The argument can be made that article 20 liability will cover a joint-stock company that has issued securities because, in a way, the company is a signatory to a prospectus through its officers and directors who physically signed the document. However, this is not the only argument that can be made under article 20 and, in any case, the issuer's liability is contemplated under article 24. Since the Decree does not indicate who exactly must sign the prospectus, it is possible that certain categories of persons who participate in a public offering but have not signed the prospectus will escape liability. This is a serious loophole in the Decree. Even though article 20

268. See *supra* text accompanying notes 236-43.

269. Section 11 of the Securities Act specifically bars suit by a person who "at the time of such acquisition . . . knew of such untruth or omission." 15 U.S.C. § 77k(a).

270. Article 8(4) provides:

Citizens and juridical persons must act in good faith, reasonably, and justly when effectuating the rights which belong to them, complying with the requirements contained in legislation The good faith, reasonableness, and justness of actions of the participants of civil legal relations shall be presupposed.

CIVIL CODE, *supra* note 104, art. 8(4).

delegates to the NSC the authority to clarify the provisions of this article, the better solution would be to enumerate signatories to a prospectus in the Decree, as is done in section 6(a) of the Securities Act of 1933.²⁷¹

If the liability of issuers in primary distributions is more or less clear under the Decree, the civil liability of securities professionals for misconduct in secondary trading is very limited. An industry professional may lose his or her license for violation of the trading rules,²⁷² but revocation of a license is of little value to the defrauded investor who has lost all of his or her money. Besides, the enforcement abilities of the NSC are certainly not enough to uncover and prosecute each and every case of the securities fraud. Consider the following statement that advocates the need for private enforcement in the context of the U.S. securities laws:

Not only do the various private remedies provide relief to those harmed by a securities law violation, but more importantly the existence of a private remedy is a powerful incentive for individuals and companies to comply with the securities laws. The latter is especially significant in light of the Commission's resources for oversight and enforcement; . . . its staff is more highly concentrated on the regulatory aspects of its mission than on enforcement.²⁷³

This proposition is even more true for the Kazakhstani situation. The NSC is much less experienced in the enforcement of securities laws than is the SEC. Also, the NSC is faced with a tremendous regulatory task; the whole regulatory scheme is yet to be created. Under these circumstances, the NSC's enforcement activities will either be very limited or will be done at the expense of regulatory work. Certainly, clear delineation of the express civil liabilities of market participants in the would Decree be very helpful and the Decree should be amended to that effect. In the meantime, the articles of the Decree that outlaw certain activities should be interpreted as authorizing private rights of action.

271. 15 U.S.C. § 77f(a) (stipulating required signatories to a securities registration).

272. See Securities Decree, *supra* note 146, art. 25, para. 6.

273. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1076 (1991).

The only express civil liability in the Decree in relation to secondary trading would strike the U.S. securities lawyer as quite unusual. Article 42 of the Decree provides an express private right of action for damages against a stock exchange for failure to enforce its rules and regulations.²⁷⁴ The prevailing view in U.S. securities laws is that stock exchanges and other self-regulatory organizations are not liable to private plaintiffs for failure to enforce their rules.²⁷⁵ We can only speculate as to why the team of the U.S. securities lawyers who drafted the Decree decided to contravene precedent in the U.S. securities law. The "deep pocket theory" appears to be the most plausible explanation: in the capital-hungry Kazakhstani market, the stock exchange is probably one of a very few defendants that can satisfy a judgment against it and successfully pass the costs of liability on to the industry.

Another possible reason for such liability is based on the perception that a stock exchange is more of a profit-making establishment, unlike the New York Stock Exchange and other U.S. self-regulatory organizations, which are organized as not-for-profit corporations with extensive regulatory functions. The likelihood that this view has actually influenced the drafters of the Decree is supported by the fact that the liability of the stock exchange is the only express civil liability of market participants. Although the for-profit nature of the now-existing Kazakh Stock Exchange may well dominate its regulatory function in today's reality, such a view discounts the self-regulatory role of the stock exchange "designed to prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade"²⁷⁶ If Kazakhstan wants to create a viable securities market, it should rethink its position with respect to the organization of the stock exchange.

In order to successfully assert an article 42 action, a plaintiff must establish that the stock exchange failed to enforce its rules in good faith and, as a result of such failure, the plaintiff sustained damages.²⁷⁷ How strict or lenient the Kazakhstani

274. Securities Decree, *supra* note 146, art. 42.

275. See, e.g., *Walck v. American Stock Exch., Inc.*, 687 F.2d 778, 786 (3d Cir. 1982) (Congress did not intend to give a private right of action under section 6 of the Securities Exchange Act).

276. Securities Exchange Act of 1934 § 6(b)(5), 15 U.S.C. § 78f(b)(5) (1994).

277. Securities Decree, *supra* note 146, art. 42. Although article 42 does not

courts may be in interpreting this provision remains to be seen but, even on its face, article 42 gives the stock exchange a good faith defense to any action against it. Therefore, one can envision many situations in which a direct action against an unscrupulous market participant, rather than against the stock exchange, will be more fruitful.

The Decree does not specifically grant a private right of action against market participants, but it contains limitations on market participants' activities.²⁷⁸ These limitations relate mostly to insider trading.²⁷⁹ Although insider trading regulation has been subject to debate, it received universal recognition by securities regulators in the world's leading securities centers, such as the United States, the European Union, and Japan.²⁸⁰ As some commentators noted:

Reasonable or not, a fear that the average investor would respond to the belief that systematic trading advantages accrue to those "in the know" (corporate executives, their families, and friends) by withdrawing from the securities marketplace has echoed repeatedly. Also, the attack against insider trading, a campaign for fair play in the stock markets, has had enduring political appeal.²⁸¹

Kazakhstan also joined the quest for fairness in the stock market by outlawing certain activities associated with insider trading, in a manner sometimes even more rigorous than the U.S. securities regulation. Market participants who own five percent or more of the stock of an issuer are flatly prohibited from trading in the issuer's securities.²⁸² Such a flat prohibition does not exist in the U.S. securities laws.²⁸³ Also, persons who possess material non-public information may not use

specifically refer to a duty of good faith, this duty is imposed by article 8(4) of the Civil Code, which must be read in conjunction with the Securities Decree. See *supra* note 270 and accompanying text.

278. *Id.* art. 30, paras. 1-3.

279. See *id.* paras. 4-6.

280. See, e.g., Council Directive 89/592, 1989 O.J. (L 334) 30 (insider trading directive of the European Union).

281. COX ET AL., *supra* note 273, at 823.

282. See Securities Decree, *supra* note 146, art. 30, para. 1. There is an exception, however, for investment funds. See *id.*

283. Section 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p, which imposes liability for short-swing profit-making, impairs an insider's ability to trade only over a six-month time period.

it to their own personal advantage or to "tip" others.²⁸⁴ Once again, the U.S. securities statutes do not contain an "abstain or disclose" requirement. However, this theory rests on a subsequent U.S. Supreme Court opinion²⁸⁵ and, therefore, has been utilized by the U.S. drafters of the Decree. Finally, article 30 broadly defines the categories of statutory insiders: directors and officers of the issuer; market participants having a contractual relationship with the issuer; auditors of the issuer; and government employees who have access to the information about the issuer.²⁸⁶

As noted before, the Decree does not expressly grant a private cause of action against insider traders.²⁸⁷ It merely states that violators of an insider trading regulation are subject to liability "under the existing legislation."²⁸⁸ A private cause of action can be found, however, if we apply to the insider trading regulation the same analysis based on articles 7, 8, and 9 of the Civil Code, as we did with respect to article 20.²⁸⁹ Just as in article 20, the article 30 insider trading regulation gives rise to civil rights and duties that can be effectuated through the right of defense. Even though the argument for a private right of action under article 30 is not without merit, an express cause of action for insider trading certainly would have facilitated the enforcement of this prohibition.

Besides article 42 liability of the stock exchange for failure to enforce its rules and possibly article 30 liability for insider trading, the Decree contains no other anti-fraud provisions with respect to the secondary market in securities. Grounds for liability can be found, however, in the Civil Code. Article 159(9) of the Code provides that "[a] transaction concluded under the influence of fraud . . . may be deemed by a court to be invalid upon the suit of the victim."²⁹⁰ As a consequence of the fraudulent transaction, the victim has a right to a remedy of rescission.²⁹¹

The concept of fraud is not defined in the Code, probably

284. See *Chiarella v. United States*, 445 U.S. 222, 230 & n.12 (1980).

285. See *id.*

286. Securities Decree, *supra* note 146, art. 30, para. 6.

287. See *supra* text accompanying note 278.

288. See Securities Decree, *supra* note 146, art. 30, para. 5.

289. See *supra* text accompanying notes 236-43, 268.

290. CIVIL CODE, *supra* note 104, art. 159(9).

291. See *id.* art. 157(3).

because the Code uses this word in its conventional sense. In the securities context, however, the ordinary meaning of fraud is not always workable, especially as applied to market manipulation.²⁹² The reasons for the expansion of the concept of fraud in application to the securities industry were succinctly stated in *Charles Hughes & Co. v. SEC*:

[The securities firm is] under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions. . . .

We need not stop to decide . . . how far common-law fraud was shown. For the business of selling investment securities has been considered one peculiarly in need of regulation for the protection of the investor.²⁹³

Therefore, Kazakhstani securities regulators should not rely on generic civil liabilities, but rather should add anti-manipulative and anti-fraud provisions to the Decree, specifically tailored to fight securities fraud and market manipulation in the secondary market.

The discussion of remedies and liabilities under Kazakhstani securities law would be incomplete without a discussion of limitation periods. The Decree itself does not contain any statute of limitations, but the general limitations period under the Civil Code is three years.²⁹⁴ The parties may not, by an agreement or otherwise, change the duration of the limitations period.²⁹⁵ The commencement of the limitations period is subject to a discovery rule: the limitations period begins to run when a person knew or should have known that his or her rights were violated.²⁹⁶ Thus, a limitations period under the Kazakhstan Civil Code may be longer than most statutes of limitations under the U.S. securities laws, which allow an action to be brought within one year from discovery of untrue facts but no more than three years from the date of occurrence or event giving rise to the cause of action.²⁹⁷

292. See discussion *supra* notes 136-40 and accompanying text.

293. 139 F.2d 434, 437 (2d Cir. 1943).

294. CIVIL CODE, *supra* note 104, art. 178(1).

295. See *id.* art. 177(2).

296. See *id.* art. 180(1).

297. See Securities Act of 1933 § 13, 15 U.S.C. § 77m (1994) (false registration

The overview of the Decree on Securities of the Republic of Kazakhstan and its comparison to the U.S. securities laws is far from complete. But even a cursory look at the Decree shows that it lays down some basic rules for a securities market. At the very least, the Decree gives an investor in the Kazakhstani market the ability to purchase a registered security accompanied by a disclosure statement through a licensed securities professional where both the issuer of a security and the securities professional are subject to liability for any fraudulent acts. Even though these rules may be imperfect, they bring some investor protection to the securities trading in Kazakhstan. Without that protection, a securities market in Kazakhstan is impossible, regardless of its economic conditions.

C. The Next Step in Securities Regulation—Investment Company Law

While there is hardly any doubt about the need for securities regulation in Kazakhstan, the extent to which the industry must be regulated presents a more difficult question. At this stage, the Kazakhstani government has made only the first steps toward regulating the securities market. Much more has to be done to assure the proper functioning of this market. In particular, the specifics of the privatization program in Kazakhstan, which is conducted primarily through investment funds,²⁹⁸ calls for special legislation governing investment companies.

The need for the regulation of investment companies stems from the nature of their assets. The Report by the U.S. Senate Committee on Banking and Currency made before the enactment of the Investment Company Act vividly shows the necessity of such legislation:

The assets of [investment] companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploi-

statements and misleading prospectuses); Securities Exchange Act of 1934 § 9(e), 15 U.S.C. § 78i(e) (manipulation of securities prices); *id.* § 18(c), 15 U.S.C. § 78r(c) (misleading statements); *see also* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 361 (1991) (applying one-year/three-year scheme to implied rights of action).

298. *See supra* text accompanying notes 95-98.

tation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders. It is obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies and that deficiencies which have occurred in the past will continue to occur in the future.²⁹⁹

The same considerations as those advanced in the Senate Report apply equally—and maybe even more so—to the Kazakhstani securities market. Kazakhstani investors are even less experienced than their American counterparts were in 1940. Kazakhstani investment funds,³⁰⁰ which produce exorbitant and easily obtainable profits in an economy plagued by capital deficiency, present an attractive target for organized crime. Under such circumstances, there is hardly any question about the need for an investment company law. Therefore, in the fall of 1994, the US AID team submitted to the Kazakhstani legislature, in addition to the Decree on Securities, a draft of the Law on Investment Funds and Companies (ICL Draft).³⁰¹

Although the ICL Draft uses many provisions of the U.S. Investment Companies Act of 1940 (1940 Act),³⁰² it is much simpler and shorter than the 1940 Act. The simplicity of the ICL Draft is more suitable to the local conditions in Kazakhstan. Clearly, the Kazakhstani market does not need such a complex regulation of investment companies, as provided by the 1940 Act. However, the market does need some legislation that will demonstrate the government's willingness to

299. SENATE COMM. ON BANKING AND CURRENCY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775, at 6 (3d Sess. 1940).

300. For a discussion of Kazakhstani investment funds and their role in the Kazakhstani privatization program, see *supra* text accompanying notes 27-28.

301. See Memorandum from Gregory Vojack to Alti A. Tleuberdin, Presidential Aide (Oct. 5, 1994) (on file with the *Brooklyn Journal of International Law*); Law on Investment Companies in the Republic of Kazakhstan (Proposed Official Draft 1994) [hereinafter ICL Draft] (translated version on file with the *Brooklyn Journal of International Law*).

302. Investment Companies Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (1994).

regulate investment companies. In that respect, the purpose of the ICL Draft is similar to that of securities regulation in other developing countries; it is designed to create "an improved sense of fiduciary obligation and commercial morality, without which it is difficult to imagine broad public participation in the capital markets."³⁰³

Article 1 of the ICL Draft defines an Investment Company as:

[A] specialized organization professionally engaged in attraction of monetary resources by means of issuing securities for the purpose of further investing them into other [issuers'] securities, and also management of portfolios of investment securities owned by the Company. Any economic entity regardless of its property forming the authorized fund through an open distribution of securities using 40% or more of its net assets for investment into Investment Securities shall be regulated by the norms of this law.³⁰⁴

This definition presents a simplified version of section 3(a) of the 1940 Act.³⁰⁵ Unlike the 1940 Act, the ICL Draft does not cover issuers that issue "face-amount certificates of the installment type."³⁰⁶ Most likely, this omission occurred not because the drafters of the ICL Draft did not perceive such issuers as investment companies, but merely because these instruments are non-existent on the Kazakhstani market. In all other respects, the definition serves the same role as the definition in section 3(a) of the 1940 Act: a company may become an investment company either against its wishes or merely inadvertently.³⁰⁷

Just as in the 1940 Act, the ICL Draft definition concentrates on two aspects of a company that make it an investment company: the type of business carried out by the company (investment of monetary resources in securities) and the type of holdings of the company (forty percent or more of securities

303. Poser, *supra* note 41, at 1293 (describing the goals of the Brazilian Capital Markets Law, but equally applicable here).

304. ICL Draft, *supra* note 301, art. 1.

305. Investment Companies Act of 1940 § 3(a), 15 U.S.C. § 80a-3(a) (1994).

306. *Id.* § 80a-3(a)(2).

307. See 1 TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* A§1, at 198 (1978).

of other issuers).³⁰⁸ To avoid an inadvertent inclusion of holding companies within the definition of investment companies, the stock of the company and its subsidiaries are excluded from the definition of Investment Securities.³⁰⁹

An investment company must be set up in the form of an open joint-stock company.³¹⁰ This approach is very different from that of the 1940 Act, which left the investment companies relatively free to organize in any form they wish.³¹¹ It is possible that the authors of the ICL Draft were concerned with the fact that interests in limited partnerships (another possible form of an investment company) and other investment arrangements are not securities within the definition of the Securities Decree³¹² and, therefore, are not subject to its registration requirements.

Under the ICL Draft, an investment company must include the words "investment company" in its name,³¹³ no other company may use such designation.³¹⁴ This requirement echoes section 35(d) of the 1940 Act³¹⁵ and the provisions of general corporation laws that attempt to prevent companies from deceiving the general population by using misleading names.³¹⁶

The ICL Draft envisions two types of investment companies: open and closed.³¹⁷ An open type of authorized fund of an investment company is a fund that issues securities with an obligation to redeem them, and a closed type of authorized fund of an investment company is a fund that does not have such obligation.³¹⁸ The classification of investment companies under the ICL Draft is the same as the one used for investment companies in section 5 of the 1940 Act.³¹⁹ Just as with

308. ICL Draft, *supra* note 301, art. 1.

309. *See id.* art. 2, para. 7.

310. *See id.* art. 4, para. 1.

311. *See* 1 FRANKEL, *supra* note 307, A§2, at 199.

312. *See supra* notes 150-54 and accompanying text.

313. ICL Draft, *supra* note 301, art. 4, para. 2.

314. *Id.*

315. Investment Companies Act of 1940 § 35(d), 15 U.S.C. § 80a-34(d) (1994).

316. *See generally* Lucian Wayne Beavers & William R. Laney, *Choosing and Protecting the Corporate Name*, 30 OKLA. L. REV. 507, 518-22 (1977).

317. ICL Draft, *supra* note 301, art. 2, paras. 5-6.

318. *See id.*

319. Investment Companies Act of 1940 § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (open-end companies—those that issue redeemable securities); *id.* § 5(a)(2), 15 U.S.C.

the definition of an investment company, the ICL Draft does not include certain types of investment companies, such as unit investment trusts³²⁰ and face-amount certificate companies.³²¹ Once again, the drafters chose not to include the structures that do not exist on the market and are unlikely to appear in the foreseeable future.

The provisions of articles 9, 10, and 11 are the core of the ICL Draft.³²² These provisions deal with the registration of investment companies.³²³ The second clause of article 9 of the ICL Draft provides that the securities of an investment company are subject to the registration requirements of the Securities Decree.³²⁴ This provision makes it clear that other registration requirements, as they pertain to the investment companies and its management, do not relieve the company from an obligation to register its securities under the Securities Decree.

Article 10 requires an investment company to obtain a license as a market participant from the NSC.³²⁵ In that respect, the regulatory scheme of the ICL Draft follows the ideology of the 1940 Act, which requires all investment companies to register under this Act.³²⁶ A few major differences between the ICL Draft's and the 1940 Act's registration requirements demand special attention. First, unlike the 1940 Act, which has its own registration requirements, the ICL Draft subjects investment companies to the same licensing requirements imposed upon broker-dealers and other market partici-

§ 80a-5(a)(2) (closed-end companies—those that issue non-redeemable securities).

320. *See id.* § 4(2), 15 U.S.C. § 80a-4(2).

321. *See id.* § 4(1), 15 U.S.C. § 80a-4(1).

322. ICL Draft, *supra* note 301, arts. 9-11.

323. Registration requirements are arguably the most important part of any legislation addressing investment companies. As David Schenker testified at the hearings before the Senate Committee during deliberations over the 1940 Act: "[S]ection 7 [the registration requirements of the 1940 Act] . . . is really the heart of the legislation An investment company, unless it is registered or exempt, cannot engage in any business in interstate commerce and it cannot control any company which is engaged in interstate commerce" *Investment Trusts and Investment Companies: Hearings on S. 3580 Before the Subcomm. on Securities and Exch. of the Senate Comm. on Banking and Currency*, 76th Cong. 198 (3d Sess. 1940) [hereinafter *1940 Senate Hearings*] (statement of David Schenker, Chief Counsel, SEC, Investment-Trust Study).

324. ICL Draft, *supra* note 301, art. 9, para. 2.

325. *Id.* art. 10.

326. Investment Companies Act of 1940 § 7(a), 15 U.S.C. § 80a-7(a) (no company can do business unless registered); *id.* § 8, 15 U.S.C. § 80a-8 (registration requirements).

pants.³²⁷ This solution provides uniformity in licenses for all market participants and makes it easier for the NSC, which has yet to acquire expertise and powers similar to those of the SEC, to control the process of licensing. Second, unlike the 1940 Act, which specifies exemptions for certain investment companies,³²⁸ the ICL Draft has no exemptions from its licensing process. In that respect, the Draft adheres to the same rigid principles as the Securities Decree.³²⁹

The final licensing requirement of the ICL Draft pertains to managers of investment companies. The ICL Draft defines a company's manager as "any person holding a license for managing a Company within the statutorily set confines who has signed a contract to manage the Company."³³⁰ These persons, according to article 11 of the ICL Draft, must be licensed by the NSC.³³¹ This provision most closely parallels section 203 of the Investment Advisers Act,³³² which requires investment advisers to register with the SEC, and carries the same purpose of taking "a compulsory census of the industry and [preventing] persons with certain criminal records from acting as investment advisers."³³³ To that end, a person who has been found guilty of violating Kazakhstani laws on securities, forgery or counterfeiting is prohibited from being employed as a manager of an investment company.³³⁴

As we have already observed in the context of discussing the Securities Decree, Kazakhstani securities laws follow the philosophy of the U.S. securities laws in that the government does not guarantee the quality of investments, but rather assures that all the information is disclosed to the investing public.³³⁵ Similarly, during the Congressional hearings of the 1940 Act, the SEC emphasized time and again "that the investors are the judges of the legal and economic arrangements which they purchase and that the [1940] Act does not impose

327. ICL Draft, *supra* note 301, art. 10.

328. Investment Companies Act of 1940 § 6, 15 U.S.C. § 80a-6.

329. *See supra* text accompanying notes 161-64.

330. ICL Draft, *supra* note 301, art. 2, para. 9.

331. *Id.* art. 11.

332. Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b-3 (1994).

333. 2 FRANKEL, *supra* note 307, B§1, at 103 (citing 1940 Senate Hearings, *supra* note 323, at 519 (statement of David Schenker)).

334. *See* ICL Draft, *supra* note 301, art. 19.

335. *See supra* text accompanying notes 171-73.

any standards with respect to the securities in which investment companies may invest their assets.³³⁶ Nonetheless, the 1940 Act restricted the freedom of investment companies to invest in risky ventures. United States investment companies must disclose to the investing public their investment policies in advance.³³⁷ Furthermore, investment companies must seek approval of the majority of shareholders before changing their investment policies.³³⁸ Finally, the SEC is empowered to regulate certain transactions that are deemed to be particularly risky.³³⁹

All these restrictions fight potential abuses mostly through disclosure, rather than through substantive regulation. Even though the 1940 Act imposes more substantive regulation than the other U.S. securities statutes, the substantive limits imposed on U.S. investment companies relate to acquisitions that may cause problems for acquired companies³⁴⁰ and acquisitions which may result in the duplication of managerial fees paid by the investors.³⁴¹ Still, the ICL Draft imposes many more substantive restrictions on the investment companies' activities than does the 1940 Act.³⁴² Why did the drafters of the ICL Draft abandon the disclosure philosophy generally underlying securities regulation and resort to the substantive restrictions? We can only assume that, because of the importance of investment funds in the process of privatization, the drafters of the ICL Draft wanted to make sure that these funds will not undermine public trust in privatization by engaging in fraudulent practices. Whatever the reasons, the anticipatory nature of the Kazakhstani securities regulation probably justifies the inclusion of more substantive restrictions than in traditional responsive securities regulation.

As a part of its substantive mandate, article 15 of the ICL Draft prohibits investment companies from conducting any

336. 3 FRANKEL, *supra* note 307, A§1, at 231 (citing 1940 Senate Hearings, *supra* note 323, at 223 (statement of David Schenker)).

337. See Investment Companies Act of 1940 § 8(b)(1)-(3), 15 U.S.C. § 80a-8(b)(1)-(3) (1994).

338. See *id.* § 13(a)(3), 15 U.S.C. § 80a-13(a)(3).

339. See, e.g., *id.* § 12(a)-(b), 15 U.S.C. § 80a-12(a)-(b).

340. See, e.g., *id.* § 12(d)(1)(A)(ii), 15 U.S.C. § 80a-12(d)(1)(A)(ii); *id.* § 12(g), 15 U.S.C. § 80a-12(g) (as applied to ownership by investment companies of securities issued by insurance companies).

341. See *id.* § 12(d)(1), 15 U.S.C. § 80a-12(d)(1).

342. ICL Draft, *supra* note 301, art. 15.

activity other than the business of investment, or activity related to the business of investment.³⁴³ Financial soundness of an investment company is assured by forbidding it to borrow money from a bank to buy securities;³⁴⁴ to issue guarantees of any kind;³⁴⁵ to perform mortgage transactions;³⁴⁶ to incur debt above the limits prescribed by the NSC;³⁴⁷ or to invest in securities of one issuer above the limits prescribed by the NSC.³⁴⁸ An investment company is also restricted in its ability to limit the voting powers of its investors-shareholders: Article 15 prohibits issuance of preferred shares.³⁴⁹

An investment company is prohibited from purchasing voting shares of a joint-stock company if such a purchase results in the investment company's affiliated group ownership of the joint-stock company's voting shares in amounts exceeding the NSC limits.³⁵⁰ Finally, for purposes of investor protection, investment companies may not engage in short sales or purchases of securities;³⁵¹ invest in its own securities or in securities of other investment companies, except for mergers;³⁵² or invest in securities which may subject the investment company to full liability for the issuer's business.³⁵³

The final important aspect of the ICL Draft regulatory scheme is that it creates express civil liability, for a company and its manager, to shareholders for damage caused to the company and its shareholders.³⁵⁴ This simple liability provision is the ICL Draft's substitute for the complex scheme of express and implied rights of action under the 1940 Act.³⁵⁵

343. *Id.* para. 3.

344. *See id.* para. 4.

345. *See id.* para. 10.

346. *See id.*

347. *See id.* para. 9.

348. *See id.* para. 6.

349. *Id.* para. 4.

350. *See id.* para. 5.

351. *See id.* para. 8.

352. *See id.* para. 14.

353. *See id.* para. 11.

354. *Id.* art. 17, para. 2.

355. The 1940 Act gives an express right of action to investment companies' shareholders for an investment adviser's breach of fiduciary duty. *See* Investment Companies Act of 1940 § 36(b), 15 U.S.C. § 80a-35(b) (1994). In addition, there is an express right of action for short-swing profit taking by insiders. *See id.* § 30(f), 15 U.S.C. § 80a-29(f). Finally, the 1940 Act, because of its broadly remedial nature, was held to provide a host of implied rights of action. *See* 4 FRANKEL, *supra*

Moreover, article 17 of the ICL Draft is a reference provision, rather than a straight grant of a right of action: it refers, for purposes of finding liability, to the laws of the Republic of Kazakhstan.³⁵⁶ Therefore, article 17 liability is founded on liability pursuant to the Civil Code of Kazakhstan. The general remedies under the Civil Code are discussed elsewhere in the article.³⁵⁷ It is useful, however, to emphasize once again that generic civil remedies do not always fit the securities market. Since the law has not yet been adopted, the Kazakhstani legislature has an opportunity to include in the ICL Draft more specific, express liabilities provisions.

As a very brief overview of investment companies regulation in Kazakhstan indicates, the ICL Draft is a simplified version of the 1940 Act, which is the longest and probably the most complex legislation among all five federal securities statutes.³⁵⁸ The simplicity of the ICL in comparison to the 1940 Act is justified by the conditions of the Kazakhstani market. Most of the complexities of the 1940 Act are inapplicable to the investment vehicles that exist in Kazakhstan. Although securities regulation should be made with an eye toward future developments, excessively complex regulation could unduly burden the Kazakhstani market, which simply does not have the capacity to generate the structures envisioned by such regulation. In the case of the ICL Draft, it appears that this simple and straightforward law, if adopted, will serve its main goal of creating an improved sense of fiduciary obligation and commercial morality.³⁵⁹ It will send a message to the investment funds and their management that attempts to defraud investors by using an investment company status will not be tolerated and that the Kazakhstani government has a legislative tool to fight such attempts.

note 307, B§8.1, at 539 (citing *Brown v. Bullock*, 194 F. Supp. 207, 223-28 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961)).

356. ICL Draft, *supra* note 301, art. 17, para. 2.

357. *See supra* text accompanying notes 236-43, 258, 270, 289-91.

358. *See* 1 FRANKEL, *supra* note 307, at xiii.

359. *See supra* note 303 and accompanying text.

IV. CONCLUSION

Dean Robert Clark broke down the history of capitalism into several stages.³⁶⁰ In the first stage, the economy was dominated by entrepreneurs, also called robber barons, who managed their own capital.³⁶¹ This stage lasted throughout the nineteenth century and was characterized by the enactment of general incorporation statutes and "enabling" laws.³⁶² As the economy developed further, new ventures required extensive investments of capital in the amounts beyond the resources of even the richest entrepreneurs. At this point, "the entrepreneurial function was split into ownership and control," and capitalism entered its second stage of professional management.³⁶³ This stage "required the legal system to develop stable relationships between professional managers and public investors, ostensibly aimed at keeping the former accountable to the latter, but also at placing full control of business decisions in the managers' hands."³⁶⁴ The U.S. government responded to this new trend by adopting federal securities laws.³⁶⁵ The third stage has further separated ownership into capital and investment and professionalized investment management.³⁶⁶

The development of capitalism in Kazakhstan and the rest of the former communist bloc hardly fits the model suggested by Dean Clark. There, although capitalism is undergoing stages of development, the lines between stages are blurred and the transition from one stage to another is occurring with lightning speed. Only yesterday, just a handful of businessmen unexpectedly emerged from a barren Soviet economy with courage enough to jump into the stormy waters of free entrepreneurship. Today, we already see an increasing class of people who have accumulated significant capital and are now willing to invest this capital by using the services of professional managers.

360. Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 562-69 (1981).

361. *See id.* at 562.

362. *See id.*

363. *Id.* at 563.

364. *Id.*

365. *See id.*

366. *See id.* at 564.

The governments of former communist countries do not have the luxury of an evolutionary, slow-going development of capitalism. While the Rockefellers and the Vanderbilts learned the basics of capitalism from their own experience, Soviet capitalists have scores of academic works and dozens of mentors available at their disposal. And these Western mentors teach them not only the principles of honest business and fair dealing, but also fraudulent tricks and deceptive devices perfected throughout the history of capitalism. In fact, fraud and deceit are so common among these new capitalists that the governments of the former Soviet Republics cannot even afford a quick response to economic changes; they have to anticipate these changes and act accordingly.

From that point of view, it is not too early for securities regulation in Kazakhstan, and may, in fact, be a little late. It is true that Kazakhstani securities regulators and the Kazakhstani judiciary do not have sufficient expertise to handle complex securities matters. Countless regulations need to be adopted to assure proper functioning of the market. The accounting system has to undergo cardinal changes to make financial statements truly indicative of the companies' financial health. But all these problems must be resolved before, not after, the securities market in Kazakhstan has reached its full capacity.

Certainly, the Kazakhstani market has a great deal to offer investors, both Western and domestic. And the fact that this market has already caught the eye of reputable Western investment funds is further evidence of its potential. Whether this potential is to be realized is a question to be resolved by the market regulators. Only they can assure the smooth operation of the market and thereby attract investors to it. The alternative is a gradual withdrawal of all investments and extinction of the market.

The average investor has a relatively low tolerance for unjustifiable risks, such as chaos in a market. He or she will not become active in the market as long as a chaotic state exists and as long as the only law that governs such a market is "kill or be killed." Investors want to have a certain degree of confidence in the market, and only governmental regulation of the market can give them such confidence. Nobody expects the government to guarantee the economic value of investments, but at the very least, investors want to be sure that they will

not be cheated out of their life savings by crooked brokers running sham operations. This assurance is something that the government can provide.

At present, the Kazakhstani securities market and its regulation are more of a fairy tale than a reality. There is a good chance, however, that a securities market in Kazakhstan will be created because Kazakhstan is ready, willing, and able to undergo the process of transformation of a securities market on paper into a real securities market. The process may take a long time, but the first pieces of legislation reviewed in this article demonstrate that Kazakhstan is moving in the right direction.

Traditionally, the securities markets in the world were initiated by merchants; governments intervened only decades later. In the process of studying Kazakhstan and other former Soviet Republics, we observe a completely different phenomenon. The government regulation of securities in these countries is designed primarily to develop and build the market. Whether or not this experiment will succeed remains to be seen. At the present time, the probability of success of anticipatory securities regulation in Kazakhstan can be expressed by Professor Poser's view of developmental securities regulation in Brazil, which is equally applicable to Kazakhstani securities regulation:

[The Brazilian program of securities regulation] represents a conscious attempt to alter habits of investment and to build capital markets through the creation of high legal and ethical standards of behavior—a "climate" in which mutual confidence between company managements, financial intermediaries, and investors can exist. Although it is still too soon to estimate its success, I believe that it is already beginning to change the attitude of . . . investors toward the stock market, if only because the very interest that the [Brazilian] government has shown is taken by many to mean that these markets have a promising future.³⁶⁷

Such is the promising future of the Kazakhstani securities market.

367. Poser, *supra* note 41, at 1306.

