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The Stock Markets of Russia and Kazakhstan: Prospects for Integration



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Abbreviations

ADR – American Depositary Receipt

APF – accumulative pension fund

CIS – Commonwealth of Independent States

EDB – Eurasian Development Bank

ETS – Eurasian Trading System

EurAsEC – Eurasian Economic Community

FATF – Financial Action Task Force

FFMS – Federal Financial Markets Service

FSA – Agency for Regulation and Supervision of the Financial Market and Financial Organisations of the Republic of Kazakhstan

GDP – gross domestic product

GDR – Global Depositary Receipt

IASE – International Association of Stock Exchanges of the CIS

IFC – international financial centre

IOSCO – International Organisation of Securities Commissions

KASE – Kazakhstan Stock Exchange

KDR – Kazakh depositary receipt

MICEX – Moscow Interbank Currency Exchange

MONEYVAL – Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism

OECD – Organisation for Economic Cooperation and Development

PARTAD – Professional Association of Registrars, Transfer Agents and Depositories of Russia

RDR – Russian depositary receipt

RFCA – Regional Financial Centre of Almaty

RTS – Russian Stock Exchange

SEA – Single Economic Area

Main Conclusions

This study, conducted by the Eurasian Development Bank with support from the PARTAD, provides an assessment of the prospects and challenges of integration of the capital markets of Russia and Kazakhstan. Our analysis of the legal framework for mutual penetration of Russian and Kazakhstani capital in the form of stock market instruments shows that there are no insurmountable barriers to this process. Moreover, the basic legal preconditions for this mutual penetration are all in place. However, as the financial crisis persists and the capital markets of Russia and Kazakhstan fail to function as a single financial centre in the global financial market, these established preconditions are still of limited use.

Notably, these two EurAsEC member countries have no explicit political or other barriers to integration of capital markets. This warrants synchronisation of their regulatory systems and infrastructure, which will allow them to quickly and efficiently organise, for instance, trading in Kazakhstani securities and depositary receipts on Russian stock exchanges; to secure reliable communication between the holder, the issuer and the registrar by electronic document management systems; and to enable the disclosure of information on these financial instruments at a single EurAsEC centre, irrespective of location, in both Russian and English.

The survey of stock market participants reveals that potential issuers and professional players currently show little interest in the integration of the stock markets of Russia and Kazakhstan and prefer international markets. Thus, competition with other financial centres necessitates significant efforts to improve the attractiveness of regional financial solutions and instruments.

To this end, the establishment of a common Eurasian financial centre with infrastructure elements located across EurAsEC countries and form a single exchange, clearing and settlement system should be the ultimate goal. Existing economic or technical advantages mean that most of these elements will be concentrated in Russia, however, the EurAsEC members (primarily Kazakhstan) will have a role to play in the capital and physical infrastructure of the main institutions of this supranational financial centre.

As part of this effort, the EDB can position itself as a unique institution which can not only catalyse the investment process but also serve as an infrastructure bridge between the capital markets of Russia and Kazakhstan and, potentially, other EurAsEC countries. It is of particular importance because, according to our survey, the level of mutual Russian and Kazakhstani capital market penetration does not match the actual potential for bilateral cooperation.

Decision-making on capital market integration issues could be greatly accelerated if, following the inception of the Customs Union of Russia, Kazakhstan and Belarus (which seemed unrealistic just a short time ago), the issue of a common currency is once again placed on the political agenda. The adoption of a common currency would spur diverse synergetic effects in the economies of the member countries. In the short- to medium term a broader use of national currencies in mutual trade could have positive effect on the integration of capital markets.

To date, the most serious concerns are centred around the fact that, though the Russian economy faces the challenges of post-crisis rehabilitation, no strategic documents or policies have yet been formulated on the development of the Russian financial market as the backbone of an integrated EurAsEC capital market. This is a dangerous oversight as competition between the developing markets is tough.

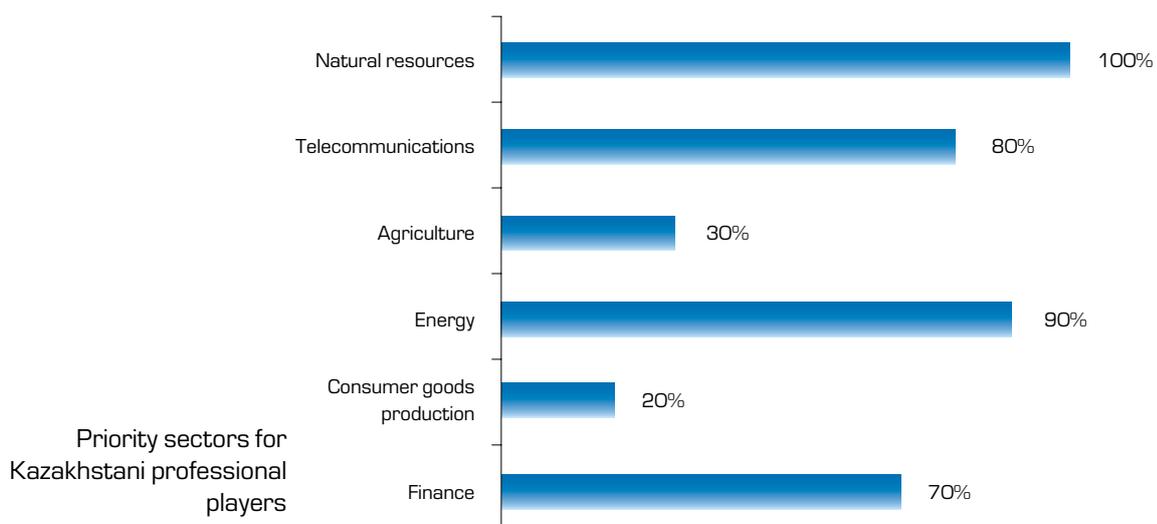
We hope that this publication will contribute to the policy-making and formulation of measures for the development of the capital markets in Russia and Kazakhstan. The main conclusions of the study are presented below.

Opportunities for mutual penetration in the Russian and Kazakhstani stock markets

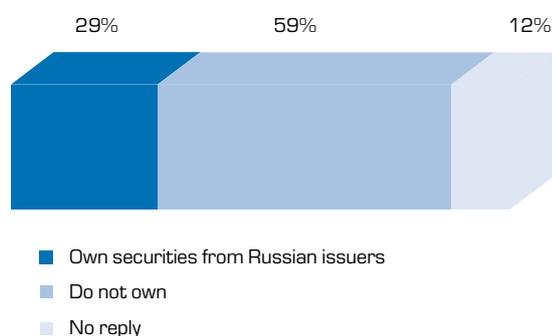
- Extensive economic ties between Russia and Kazakhstan open opportunities for closer interaction between the national stock markets. The most important issue here is perfection, harmonisation and unification of the legal framework for the issuance of, and trading in securities and the activities of professional stock market players.
- Some regulatory provisions and mechanisms for trading and placement of foreign securities on Russian and Kazakhstani markets are already in place.
- Free trading in Russian and Kazakhstani securities (registration of transactions) in each other’s territories, including organised markets, is technically impossible unless registrar licences become mutually recognised.
- In the case of Russian and Kazakh depository receipts (RDR and KDR), the legislation was passed ahead of market needs, as not a single issuance has been registered to date.
- Integration of the securities markets of two states is still at an initial stage. Both Russian and Kazakhstani regulations provide for foreign securities turnover on the national organised markets, but currently Russian regulations contain more restrictions compared to those of Kazakhstan.

Needs and preferences in respect of the mutual penetration of stock markets: survey results

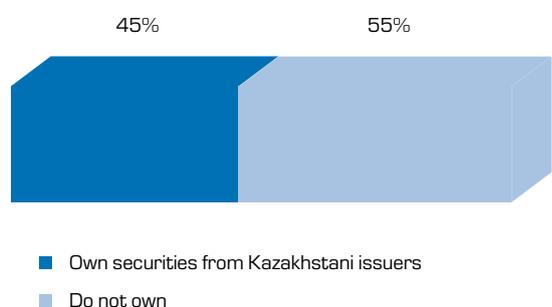
- Kazakhstani players are interested in Russian financial market as a source of financial resources. By contrast, Russian businesses view Kazakhstani capital market as a springboard to Kazakhstan’s natural resources. As one would therefore expect, most Kazakhstani organisations are keen to have their securities traded on the Russian market, whereas Russian companies are not interested in the Kazakhstani market in this way.
- Natural resources, financial institutions, energy, and telecommunications are the priority sectors for Kazakhstani professional stock market players. Russian players only indicated interest in the natural resources sector and in Kazakhstani financial institutions.



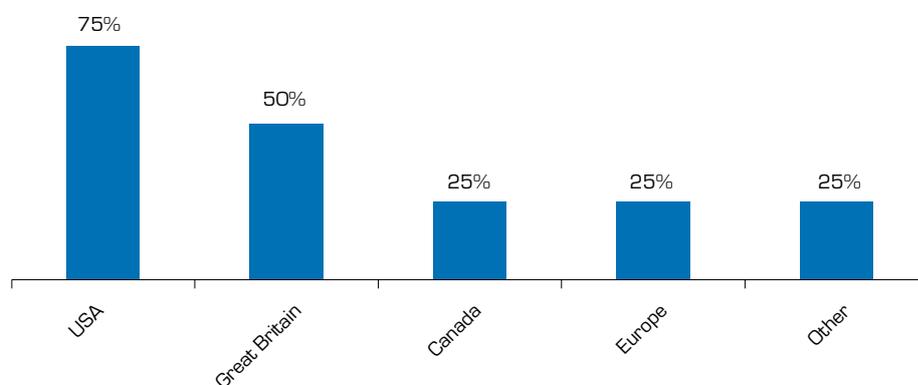
- Most of the Kazakhstani organisations that already hold Russian securities intend new purchases in the next six months. Over 30% of respondents intend to buy Russian securities for the first time. Some respondents pointed out that they buy Russian securities in the form of GDR or ADR internationally rather than from the Russian stock exchanges.



Kazakhstani ownership of Russian securities

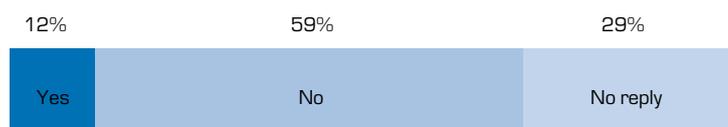


Russian ownership of Kazakhstani securities



Kazakhstani ownership of other countries' securities

- At present, Kazakhstani issuers are not interested in the Russian market and most of them have listed their securities on the LSE. Direct trading in foreign securities on Russian stock exchanges is limited by excessive legal restrictions.



Interest in having securities listed in Russia

- As the financial crisis persists and the capital markets of Russia and Kazakhstan still have insufficient integration with the global market, the Russian and Kazakh legal provisions for the issuance of RDR and KDR on foreign securities in the national stock exchanges are still of limited use.

- Financial resources controlled by Russian private pension funds or management companies can be viewed as a potential source of Russian portfolio investments in Kazakhstani securities. However, to use these opportunities provided by Russian law, index funds holding Kazakhstani securities must be created. This is unlikely to happen in the near future, at least until the Kazakhstani capital market recovers from the global crisis and/or Kazakhstani securities are traded on the Russian market.
- Kazakhstani pension funds are active players on the financial markets of the republic and elsewhere. However, they should not be relied on as a means of significant investments abroad, particularly not in Russia. At present they are redirecting their investment strategy towards increasing holdings of Kazakh government securities and reducing investments in foreign securities.

Integration of Russian and Kazakhstani stock exchanges

- Our survey covered Russia's main stock exchanges (RTS and MICEX) and their Kazakh counterpart – KASE. RTS ranks first of the two in terms of investments in other country. To date, only RTS has a subsidiary in Kazakhstan (Commodity Stock Exchange ETS) and holds Kazakhstani securities.
- Russian stock exchanges are showing interest in cooperation with Kazakh partners and wish to add Kazakh instruments to their trading lists.
- Although the main responsibility for simplifying interaction between organised market players from two countries lies with stock exchanges themselves, the legislation also has an important role to play in this process. For example, both stock exchanges and professional capital market players need an adequate mechanism of nominal holding for foreign investors that should fit in with the laws of two states, and a developed clearing system, including centralised functions.
- Another important element of technical integration is the development and introduction of a common electronic document management technology, which would allow information exchange between the stock exchanges and the traders to be standardised and accelerated.
- In the short term, the main focus should be on the integration of stock exchanges of Russia and Kazakhstan as the hosts of the most developed markets in EurAsEC. A positive example of integration on the commodity market is the establishment in late 2008 of the Eurasian Trading System (ETS) commodity exchange by RFCA (40% of the charter capital) and RTS (60%).
- We should also highlight the project to create the Eurasian Stock Exchange of Agricultural Produce, Raw Materials and Foodstuffs that is being developed on the initiative of the EurAsEC Integration Committee with the participation of Russian and Kazakh partners. This basically competes with the above ETS project. The new exchange will be based on the Belarusian Universal Commodity Exchange and is expected to start in 2011. If this project becomes a success, it would be desirable for its members to find mutually acceptable mechanisms for its integration with the ETS – perhaps involving already operational trading floor in Almaty.
- During the past decade a great deal of organisational work has been carried out in both countries, however we cannot so far say that an adequate level of integration has been achieved, nor can we say that we are nearing a common stock exchange space.

Introduction

At the current stage of the economic development of post-Soviet countries their capital markets generally show very modest achievements, with only Russian and, to a lesser extent, Ukrainian and Kazakhstani markets approaching a medium level of development. With the persistent fragmentation of the economic space of the CIS and EurAsEC, less than a year ago only bilateral interaction between capital markets was deemed feasible. However, the events that took place during this short time span, particularly, the realignment of political forces in Ukraine and the inception of the Customs Union of Russia, Kazakhstan and Belarus, have created potential for advancing closer interaction of capital markets. This potential could be amplified further if Russia and Kazakhstan attempt to coordinate their initiatives to create internationally recognised financial centres in both countries.

The need for a coordinated development approach is driven by the challenges two countries have in common, combined with increasing activity in each other's stock markets by their professional players and infrastructure organisations, including the stock exchanges themselves. Enhancing the interaction between Russian and Kazakhstani capital markets is pivotal in the light of the prospective launch of Russia-Kazakhstan-Belarus Single Economic Area (SEA). This interaction could provide a basis for regional economic integration in general and promote the development of a transborder financial infrastructure in particular. Integration of financial markets will enable a more efficient application of savings and attract additional investments. Issuers will be able to reduce their borrowing costs and investors will have the opportunities to diversify their investment portfolios, resulting in lower investment risks. The funds raised on the integrated capital markets of Russia and Kazakhstan (and, prospectively, other SEA countries) can be used to finance transborder infrastructure development in various sectors.

Therefore, the assessment of the prospects for integration of the capital markets of Russia and Kazakhstan is an important stage for coordinated economic development of these countries and other EurAsEC members alike. In the present conditions, EurAsEC needs a comprehensive financial policy which must be closely related to the real sector of the economy. The assessment includes, *inter alia*, a comparative analysis of the legal framework and regulations applicable to the capital markets of both countries in order to identify critical differences and develop common approaches to common problems. Following this logic, close attention must be paid to the development of consolidated financial market infrastructure, including interconnected systems of exchange trading, settlement and clearing, in order to create the technological premises for free movement of capital.

More precise tuning of financial market regulation and infrastructure (in legal and institutional terms) will require identification of the needs and preferences of market players from both countries, and with due regard for the fact that these needs and preferences reflect the current regulatory environment and infrastructure. Overcoming the existing barriers will require an analysis at the supranational level. This report is the EDB's contribution to study and systematise the main problems impeding the integration of the capital markets of Russia and Kazakhstan.

1. Current status:

mutual penetration of stock markets and infrastructure

- At present, Russia and Kazakhstan have the most developed stock markets in the post-Soviet space.
- However, the weak legal framework renders them prone to crises and impedes mutual penetration.
- Integration of the securities markets of EurAsEC and CIS countries is still at an initial stage.

1.1. The development and main features of the stock markets of Russia and Kazakhstan

The development of the stock markets

In both Russia and Kazakhstan, the stock markets evolved in parallel with the market economy. The foundations were laid in the 1990s, when privatisation gave rise to the first joint-stock companies, broker firms and stock exchanges. Russia implemented a mass privatisation programme, and initially privatisation coupon exchange occurred outside the organised market. In Kazakhstan stock market development and privatisation of state assets proceeded simultaneously – through public placements on the young stock exchange. This resulted in the state-initiated placements being largely sold to strategic investors, rather than the public at large.

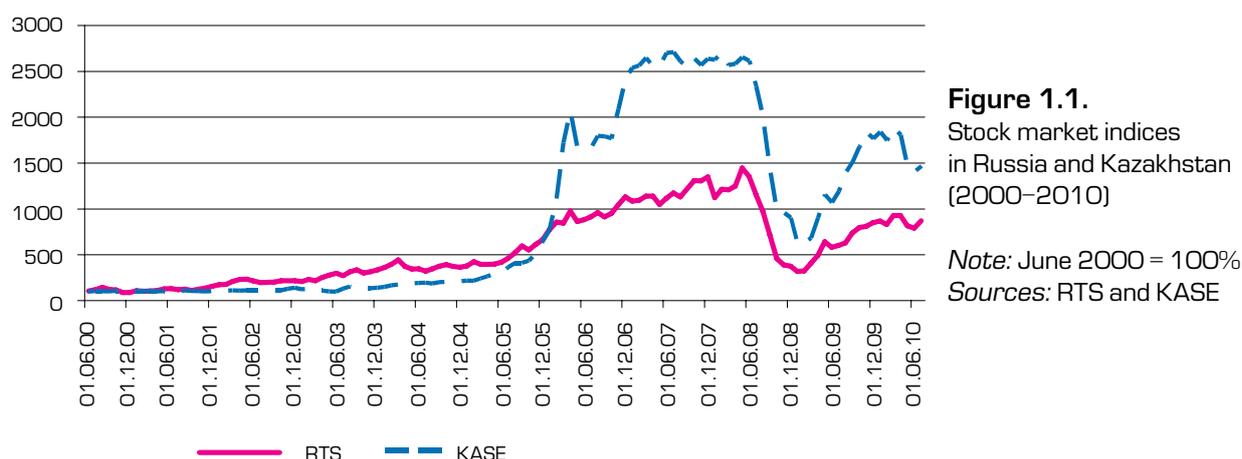
Almost simultaneously both countries adopted laws to regulate the stock market and created the necessary infrastructure, including stock exchanges, depositories and clearing agencies. Various factors, such as institution building, adoption of new laws and socioeconomic reforms eventually determined the specific features of the national markets (Golovnin et al., 2010).

Whereas in the 1990s the stock market functioned essentially as a mechanism for the redistribution of property, from the early 2000s they worked to attract investments in the economy. The first foreign securities appeared on Russian (Tararuyev, 2010) and Kazakhstani (Dontsov, 2003) stock markets, and nongovernment issuers were becoming increasingly active. However, the real investment potential of the stock markets still fell short of the countries' need for financial resources.

Between 2005 and 2007 there was an upsurge in stock market activity in both countries: the average annual growth of the Russian Stock Exchange (RTS) was 50%, whilst that of Kazakhstani Stock Exchange (KASE) exceeded 150%. Russian and Kazakhstani markets became leaders in the post-Soviet space in most parameters. For example, at the end of 2007 capitalisation of the Russian and Kazakhstani markets had reached 99.8% and 40.8% of GDP, respectively. Yet in many other qualitative characteristics (market liquidity, dividend yield, number of instruments traded) they lagged behind the leading developing markets, let alone the developed markets.

The financial crisis of 2008 seriously affected the dynamics and structure of the Russian and Kazakhstani securities markets. A dramatic capital outflow, pressing macroeconomic

problems (inflation, slowdown in industrial growth, huge external private sector debt, etc.) led to a protracted decline of the overcapitalised markets at the end of 2008 (see Figure 1.1). The level of non-residents' transactions and private investors also shrank, and other categories of investors, such as investment funds, low-keyed, too.



The decline in market capitalisation in 2008 was especially sharp in Russia and Kazakhstan, as these countries had the most open economies in the CIS. According to the CIS Executive Committee, this index dropped by more than 70% in Russia and more than 40% in Kazakhstan (CIS Executive Committee, 2009). Today the markets look more optimistic. In late June 2010 capitalisation on KASE was \$52.6 billion¹. In dynamics, this represents a 19% increase over 2009, yet it falls some 30% short of the 2008 capitalisation level. In Russia, as at September 30, 2010, total market capitalisation had reached \$817 billion – an annual growth of 21.5%, but merely 35.6% of the 2008 level².

The Russian and Kazakhstani stock markets are the unquestionable leaders in the CIS in absolute figures. Belarus has a market of government securities, but there is no notable progress in the corporate market development. In Central Asia, organised securities markets are very weak, although they have demonstrated positive dynamics in recent years.

Currently both the Russian and Kazakhstani stock markets lack a strong investor base. Many regulatory issues still need to be worked out, and market players are less protected than in developed countries. The derivatives market, which provides protection against risks, is also poorly developed. In its assessment of the stock market laws of its 29 member countries the EBRD classifies Russia and Kazakhstan as medium compliance countries by International Organisation of Securities Commissions (IOSCO) standards (EBRD, 2008).

The Russian stock market is characterised by considerable commercial bank activity. Only limited quantities of shares from Russian issuers can be found in free circulation. This situation can be explained by high concentration of shares in the hands of a limited number of holders. Individual investors have no direct access to the market, because shares are being bought up in packages by wholesale brokers and commercial banks. Institutional investors (unit and incorporated investment funds, pension funds, insurance companies) are not sufficiently represented among the professionals. On the whole, the Russian market is still largely speculative (Sergeyev, 2007).

¹ <http://www.investfunds.kz/indicators/>

² <http://stocks.investfunds.ru/indicators/capitalization/>

1. Current status: mutual penetration of stock markets and infrastructure

In Kazakhstan, banks are also active stock market players. They issue shares, bonds, bills of exchange, certificates of deposit and other instruments, act as investors and carry out agency transactions in securities (Dontsov, 2003). Companies working in the retail sector and investment services make no secret of the fact that their goal is merely to raise financial resources in Kazakhstan with a view to invest them abroad. This position bears no promise of benefit for the Kazakh economy, but nevertheless creates a competitive environment and fuels market activity (Biznes & Vlast, 2008). Pension funds had been the largest group of domestic investors prior to the crisis, but, due to their investment rules, they have currently reduced their presence on the shares and bonds market. Compared to Russia, the Kazakhstani stock market is characterised by low liquidity of the secondary market which is attributable mainly to a lack of traded instruments and poor development of the derivatives and shares markets. Many Kazakhstani issuers are still reluctant to disclose their financial information or share control over their business with external shareholders (Karagusova, 2008). Generally, these problems can be found in all CIS stock markets, and this, along with the legal barriers, impedes the integration process in the region.

Interaction between Russia and Kazakhstan in investments and finance

Economic cooperation between Russia and Kazakhstan is traditionally intensive. According to data from the System of Indicators of Eurasian Integration (EDB, 2009), the country pair Russia–Kazakhstan shows the highest level of integration in terms of mutual trade. The EurAsEC region, which both countries belong to, also records positive integration dynamics. Whereas in 2000 Russian investments in Kazakhstan accounted for as little as 0.4% of the total investments in EurAsEC countries, by 2008 this figure had increased to 7.7% (Heifetz, 2009). However, the main target for Russian investments is Belarus. Kazakhstan, on the contrary, is the main investor in Russia within the EurAsEC grouping. In 2000 Russia received 49% of all investments in EurAsEC countries, and by 2008 this figure had increased to 81%. Thus, the interaction between Russia and Kazakhstan demonstrates an upward trend (see Table 1.1).

	Russian investments in EurAsEC countries			EurAsEC countries investments in Russia		
	2000	2008		2000	2008	
	All	All	Direct and portfolio investments	All	All	Direct and portfolio investments
Belarus	490.2	771.2	661.9	2.5	103.5	32.7
Kazakhstan	2.2	99.7	30.2	5.7	894.8	228
Kyrgyzstan	0	20.6	0.1	0.1	70.5	532
Tajikistan	0	61.7	1.2	0	25.9	0
Uzbekistan	0.4	333.9	250.7	3.5	7	5.2
Total EurAsEC	492.8	1287.1	944.1	11.6	1101.7	271.1
Total CIS	555.6	2521.4	1921.3	19.3	1502.6	562.8

Table 1.1.
Accumulated mutual investments by Russia and EurAsEC countries (early 2008, \$ million)

Source: Heifetz (2009)

To date, the Russian investments in neighbouring countries (particularly, EurAsEC members) target exclusively natural resources and energy (Heifetz, 2009). In Kazakhstan, the main recipient of Russian capital is the fuel and energy complex. According to a number of open sources, many large stock market players in Russia, including RTS, MICEX, Sberbank, Depository and Clearing Company, and Rosbank, show sustained (albeit narrow) interest in cooperation with Kazakhstani securities market institutions.

Financial institutions from CIS countries are strengthening their presence on each other's markets (Golovnin, 2008). Russian and Kazakhstani banks are especially active

in foreign expansion; in particular: VTB, Sberbank and Alfa Bank of Russia and BTA Bank, Kazkommertsbank and Halyk Bank of Kazakhstan. Russian investment companies are gradually entering the emerging CIS stock markets, preferring the relatively advanced markets of Ukraine and Kazakhstan. Thus, KIT Finance and Renaissance Capital established their presence in Kazakhstan, and Troika Dialog joined them recently. In addition, two management companies (subsidiaries of Russian companies), KIT Fortis Investment Management and Avangard Capital, are now operating in Kazakhstan. Members of Kazakh banking holding companies are also present in the Russian stock market. These are typically small, except for East Kommerts investment group, which at the end of 2007 ranked 7th among Russian investment companies in terms of securities transactions.

Unlike banks and investment companies, organisations representing stock market infrastructure (stock exchanges, depositories, clearing agents) do not so far have a significant presence in other countries' markets. They interact mainly by entering into memoranda of understanding. There are three examples worth noting: KASE's shareholding in the Kyrgyz Stock Exchange; a joint project between RTS and Ukrainian investment companies to establish a new Ukrainian Stock Exchange; and a joint project between KASE and RTS to launch the Eurasian Trading System in Almaty.

As mentioned above, after the crisis of 2008–2009 the stock markets of Russia and Kazakhstan faced similar problems: a decline in liquidity, the withdrawal of foreign investors, and a drop in stock indices. Under these conditions the importance of portfolio investments grew up in both countries. According to statistics (see Table 1.2), Kazakhstan ranks 26th in terms of portfolio investments in Russia, whilst Russia ranks 11th in terms of portfolio investments in Kazakhstan.

The financial markets of Russia and Kazakhstan principally work as mechanisms for raising speculative capital which leaves the country fast during a crisis.

Investments in Russia	Volume	%	Ranking	Investments in Kazakhstan	Volume	%	Ranking
Luxemburg	5609	23	1	USA	18526	59	1
Ireland	5024	20	2	UK	1883	6	2
USA	3225	13	3	Japan	1870	6	3
Netherlands	2483	10	4	Germany	1693	5	4
Virgin Islands	1889	8	5	France	1625	5	5
Cyprus	1877	8	6	Netherlands	1553	5	6
UK	1317	5	7	Italy	766	2	7
Germany	889	4	8	International organisations	727	2	8
Australia	780	3	9	Australia	584	2	9
International organisations	505	2	10	Belgium	429	1	10
Kazakhstan	17	0	26	Russia	428	1	11

Table 1.2.
Portfolio investments
(2008, \$ million)

Source: CPIS, IMF

Official statistics indicates that mutual investments by two countries remain at a minimum level. Russian direct and portfolio investments in Kazakhstan in 2008 amounted to as little as 1.4% of all foreign investments (see Table 1.3).

Interaction between the stock markets in the CIS in the pre-crisis period was studied by Libman (2010). His calculations of stock indices correlation showed that this interaction is especially intense between the Russian and Kazakhstani markets. The correlation index in the period from July 2000 to May 2008 was 0.96. This can be explained by the high degree of convergence of two economies and the way these are regarded by foreign investors, who approach both in

1. Current status: mutual penetration of stock markets and infrastructure

Table 1.3.
Russian portfolio and direct
investments (\$ million)

Source: CIS Statistics
Committee

	From Russia to the CIS			From the CIS to Russia		
	2000	2005	2008	2000	2005	2008
Total CIS	118	162	1164	7	71	151
Azerbaijan	0	0	0	0	41	0
Armenia	0	126	437	0	4	2
Belarus	77	8	667	0	11	16
Georgia	0	0	0	0	0	0
Kazakhstan	0	1	51	0	9	104
Kyrgyzstan	0	0	0	0	0	21
Moldova	31	0	0	1	0	0
Tajikistan	0	0	0	0	0	0
Turkmenistan	0	0	0	0	0	0
Uzbekistan	0	0	0	0	1	1
Ukraine	10	27	9	6	5	7

a similar fashion. According to recent data, during the crisis (from June 2008 to December 2009) correlation increased to 0.98 – a clear sign of the strong ties between the Russian and Kazakh economies. At the beginning of 2010 the correlation of RTS and KASE indices dropped back to 0.74.

The absence of integration in Asian markets can be explained principally by low liquidity and underdeveloped financial systems, which make investors turn their attention to other financial centres.

In an attempt to identify the reasons for low financial integration observed despite intensive trade, interconnected infrastructure and close historic and cultural links, we might turn to the example of Asian countries. Traditionally, mutual trade is high, but their stock markets practically do not interact at all. The International Bank for Economic Cooperation conducted a study of integration of stock markets in Asia (Garcia-Herrero et al., 2008) and the authors put forward four hypotheses on the factors which determine the degree of interaction: 1) geographic direction of investments; 2) trade;

3) profitability; and 4) liquidity. The conclusion was that the absence of integration in Asian markets can be explained principally by low liquidity and underdeveloped financial systems, which cause investors to turn their attention to other financial centres.

Similarly, a lack of liquid instruments for institutional investors and long-term capital within the country and, as a result, outflow of large issuers towards foreign stock exchanges impede the development of the stock markets in Russia and Kazakhstan and the interaction between them.

1.2. Comparative analysis of legal frameworks and infrastructure

The extensive economic ties between Russia and Kazakhstan open opportunities for closer interaction between the national stock markets. The most important issue in this context is the enhancement, harmonisation and unification of the legal framework for the issuance of and trading in securities and the operation of professional stock market players. The current status of the legal framework deserves close attention; in *Table 1.4* we compare some critical provisions of securities market regulation in two countries.

Basic legal framework

All professional activities on the securities market are subject to licences issued by the authorised body in charge of the securities market: the Federal Financial Markets Service

1. Current status: mutual penetration of stock markets and infrastructure

	Russia	Kazakhstan
Main law	<p>The Law <i>On the Securities Market</i> (RF, 1996) provides for the following activities:</p> <ol style="list-style-type: none"> 1) brokerage; 2) dealer services; 3) securities management; 4) clearing; 5) depository services; 6) registrar services; and 7) organisation of trade in securities. <p>The federal executive body in charge of the securities market (RF, 2004) is FFMS which controls and supervises financial markets (except insurance, banking and auditing).</p>	<p>The Law <i>On the Securities Market</i> (RK, 2003a) provides for the following activities on the securities market:</p> <ol style="list-style-type: none"> 1) brokerage; 2) dealer services; 3) registrar services; 4) investment portfolio management; 5) pension fund investment management; 6) custodian services; 7) transfer agent services; 8) organisation of trade in securities and other financial instruments; and 9) depository services. <p>State regulation and supervision of the financial market is the responsibility of the Agency for Regulation and Supervision of FSA (RK, 2003b).</p>
Registrars	<p>There is a restriction on registrar services for foreigners. In accordance with the Russian Law <i>On Joint-Stock Companies</i>, for joint-stock companies comprising more than 50 shareholders a share register must be kept by a registrar. The same law also provides that for these companies the registrar may act as a tabulation commission at general meetings of shareholders. However, only companies comprising more than 500 shareholders are obliged to employ registrars to do so.</p>	<p>In accordance with the Law <i>On the Securities Market</i>, a register system is compulsory for equity securities and must be kept by a registrar. The functions of, and requirements for registrars are all set forth in the Rules of <i>Keeping a Register System</i> and are largely identical to those imposed by the Russian register rules.</p>
Depositories	<p>Under Russian law, foreign depositories are not treated as «professional securities market players» and therefore cannot be recognised as depositories or open fiduciary accounts with a Russian depository. Russian depositories can open accounts for non-resident depositories as beneficial owners only, but not as nominal holders (Aksenova, 2007).</p>	<p>Professional securities market players («nominal holders» under Kazakh law) and foreign depositories and custodians may open fiduciary accounts with the Central Depository of the Republic of Kazakhstan.</p>
Public placement and/or trading in foreign securities	<p>There is a list and a reference book of foreign instruments which the FFMS recognises as securities. Only selected securities may be publicly placed and/or traded in Russia. A precondition for the placement of foreign securities is registration of the respective prospectus with FFMS. Public placement of foreign securities is subject to approval by a stock exchange. Notably, a stock exchange may approve the placement only if the securities are listed on a stock exchange from FFMS' list (this does not apply to securities issued by international financial organisations).</p>	<p>Nongovernment securities issued under the laws of foreign states and securities of international financial organisations from the official list of the stock exchange may be traded on the organised securities market in Kazakhstan. The list of international financial organisations whose equity securities may be traded on stock exchanges is drawn by stock exchanges themselves and must be approved by the Agency of Regulation and Supervision of the Financial Market and Financial Organisations. Issuers who wish to include their shares or debt securities in the first quality sector must meet very stringent requirements.</p>
Issuance of national depository receipts representing foreign securities	<p>Russian law imposes certain requirements for RDR issuers. RDR may be issued by a depository which meets FFMS requirements as to equity capital size and has a track record of at least three years. At present, the list of permitted issuers includes 64 organisations, mainly central depositories from foreign states, including the Central Depository of the Republic of Kazakhstan.</p> <p>If the issuer of the underlying securities does not assume any obligations to RDR holders, such RDR may be issued only if the securities are listed on a foreign stock exchange from FFMS' list. Requirements for RDR registers are set forth in the rules of keeping registers of RDR holders. In accordance with these rules, a register of RDR holders may be kept either by the issuer (depository), irrespective of the number of holders, or a registrar.</p> <p>It should be noted that the law anticipated market needs, as not a single RDR issuance has been registered to date.</p>	<p>Under Kazakh law:</p> <ol style="list-style-type: none"> 1) a KDR issuer must hold a licence for custodian business; 2) the shares of a KDR issuer must be on the official highest quality list of the stock exchange; 3) a KDR issuer must have operational risk management and corporate governance systems. <p>The issuer of the underlying asset may not be registered in an offshore territory or affiliated with an organisation registered in an offshore territory, and must have a rating not lower than 'BB-' from Standard & Poor's or Fitch Rating Ltd.</p> <p>Underlying securities issued by residents of Kazakhstan must be on the official first quality list (the «Shares» sector) of a stock exchange operating in Kazakhstan. Registration and confirmation of title to KDR is the responsibility of the Central Depository of the Republic of Kazakhstan. No KDR issuances have been registered to date.</p>
Placement of national securities abroad	<p>In accordance with the Russian Law <i>On the Securities Market</i>, Russian issuers may place their securities outside Russia by various methods, including placement of securities of foreign issuers who confirm their rights to the equity securities of Russian issuers under foreign law, however, subject to FFMS approval and other conditions.</p> <p>There are a number of requirements for the number of shares of Russian issuers which are to be placed and/or traded outside Russia.</p>	<p>Residents of Kazakhstan may place their shares abroad if they are on the official first quality list (the «Shares» sector) of a stock exchange operating in Kazakhstan. In addition, Kazakhstani shares may be placed abroad if they are listed in the «Non-listed Securities» sector of a stock exchange operating in Kazakhstan.</p>

Table 1.4.
Stock market regulation in Russia and Kazakhstan

1. Current status: mutual penetration of stock markets and infrastructure

(FFMS) in Russia and the Agency for Regulation and Supervision of the Financial Markets and Financial Organisations (FSA) in Kazakhstan. The main functions of these bodies are: to create incentives for the improvement of corporate governance of financial organisations; to monitor the financial market and financial organisations in order to secure the stability of the financial system; to place an emphasis on financial market segments which are exposed to higher risks in order to maintain financial stability; to introduce modern technology; and to ensure that end users have access to all the information on the activities and services of financial organisations.

Stock market registration system

The stock market registration system consists of two groups of professional market players: registrars and depositories.

In Russia, as at July 1, 2010, only 48 professional market players held licences for registrar services. Their number shrank rapidly over recent years after the FFMS introduced the requirement that each registrar must service at least 50 issuers comprising at least 500 holders; a requirement that impedes competition. Many organisations find it difficult to overcome this administrative barrier, as there are very few initial placements and the number of shareholders in joint-stock companies tends to shrink as a result of equity consolidation. Furthermore, smaller companies are permitted to perform registrar functions by themselves. At present the FFMS does not have any real tools by which to interfere with registrar and counting commission functions in companies. Notably, it is the procedure for convening meetings and especially the absence of a clear definition of the duties of a counting commission in the law that causes many corporate conflicts.

In Kazakhstan, a register system is compulsory for equity securities and such a system must be maintained by a registrar; this represents an advantage over Russian law which allows issuers with less than 50 holders to keep registers by themselves.

In Kazakhstan, as at July 1, 2010, there were 11 licensed registrars that are entitled to engage in this business irrespective of the number of issuers they service. They interact with three licensed transfer agents. A register system is compulsory for equity securities and it must be maintained by a registrar; this presents an advantage over the Russian law that allows issuers with less than 50 holders to keep registers by themselves.

As at July 1, 2010, 738 market players held licences for depository services in Russia. Most of them use these licences for providing their clients with access to settlement and depository systems and registers, thus acting as client (custodian) depositories. Consequently, Russian professional market players and investors use the services of such depositories to dispose of shares and units in unit investment funds without directly accessing the registrar, i.e. by book-entry settlement using custodian accounts and representing the holders' interests in the register or other depository as nominal holders.

Some serious problems with regulation of depository business in Russia are associated with gaps in the Federal Law *On the Securities Market*. The situation is complicated even further by the Central Bank's wide interpretation of its authority to impose special requirements for registration of title to government securities and to issue instructions to this end without consulting with the FFMS or the professional community. As a result, depositories are forced to maintain special register systems and charts of accounts which do not comply with FFMS regulations and existing business procedures (formulated in self-regulating organisations' standard documents).

The existence of different approaches to regulation of book-entry settlement should be excluded. Imperfect regulation is a major weakness of the Russian stock market's registration infrastructure. The regulations change too often and are complicated by the established trading and registration systems.

According to FFMS requirements, the registration of title to foreign securities intended for public placement (trading) in Russia must be registered with a depository whose business meets the general requirements applicable to depositories. In addition, the FFMS imposes some special requirements on this type of depository:

- 1) it must have a track record of at least one year;
- 2) it must provide services associated with receiving yield from foreign securities or other payments to which the holder is entitled, to all persons (depositors) whose title to foreign securities it has registered.

Finally, the depository must maintain an account for each of those persons acting on behalf of other persons with a foreign registrar from FFMS' list.

These strict requirements for depositories were dictated by the problem of foreign nominal holders. It is associated with the threat of liquidity outflow, i.e. a shift of activity from Russian stock exchanges to foreign exchanges (Golovnin et al., 2010). A reluctance to operate on domestic stock markets can lead to the loss of potential market turnover in Russia and other CIS countries.

Kazakhstan has a two-tier depository system. The first tier consists of the Central Depository. The second tier is comprised of the first category brokers and dealers (who are authorised to maintain clients' accounts as nominal holders (and register transactions in securities)) and banks providing custodian services. As at July 1, 2010, there were 11 custodian banks and 81 licensed brokers and dealers. Notably, the Central Depository started to establish correspondent relations with depositories from other CIS countries earlier than its Russian counterparts (Golovnin et al., 2010).

To sum up, Russian Law *On the Securities Market* does not recognise professional market player licences issued under foreign laws. Russian registrars cannot open fiduciary accounts for non-residents, including depositories and other nominal holders, and can only open these accounts for depositories licensed by FFMS. As a result, depositories and other nominal holders cannot establish correspondent relations, which in turn preclude settlement under transactions in securities (supply of securities or money). Kazakh law already contains all the necessary provisions. Fiduciary accounts can be opened with the Central Depository of the Republic of Kazakhstan not only by nominal holders that qualify under Kazakh law, but also by foreign depositories and custodians.

Placement of foreign securities

Our comparison of two countries' legal frameworks shows that certain legal preconditions for mutual capital flows in the form of financial instruments are already there. However, the existing differences in Russian and Kazakh laws create barriers to these flows, specifically the legal restrictions on mutual access to stock markets and issuance and placement of securities.

At present, foreign securities can be placed in Russia and Kazakhstan by two methods:

- public placement and/or trading in foreign securities;
- issuance of national depository receipts representing foreign securities.

Imperfect regulation is a major weakness of the Russian stock market's registration infrastructure. This regulation changes too often and is complicated by the traditional organisation of the trading and registration systems.

The problem with foreign nominal holders is associated with the threat of liquidity loss, i.e. shift of activity from Russian stock exchanges to foreign ones.

Legal restrictions on mutual access to stock markets and issuance and placement of securities create barriers to mutual capital flows.

1. Current status: mutual penetration of stock markets and infrastructure

Importantly, a permit to trade in foreign securities on Russian and Kazakhstani stock markets can be issued by a stock exchange, subject to approval by the authorised body. In Russia, in contrast to public trading, public placement of foreign securities can be permitted only by the FFMS. In any event, public placement is initiated and performed by stock exchanges, and they are responsible for the introduction of foreign securities on the market. However, Russian stock exchanges can handle only securities that are listed on a stock exchange from FFMS' list (with the exception of securities issued by international financial organisations); furthermore, the stock exchange must be member of:

- the World Federation of Stock Exchanges;
- the Federation of Euro–Asian Stock Exchanges; or
- the CIS International Association of Stock Exchanges.

The stock exchange in question must be incorporated in one of the OECD/FATF/MONEYVAL countries. This can also be a state with which the FFMS has an [agreement on interaction](#)³. If a stock exchange withholds its permit for public placement, a permit can instead be issued by the FFMS, provided that the securities meet certain liquidity and investment risk requirements.

The Russian Law *On the Securities Market* is different in that it regulates not only public placement of, and trading in foreign securities, but also the private placement of these on the Russian stock market. Even if a foreign issuer does not intend to make an initial public offering in Russia and offers its securities to a small number of chosen investors, it must obtain a permit from the FFMS and have the prospectus registered; furthermore, it must furnish the FFMS with a notice on completion of placement.

One of the major problems which impedes introduction of foreign securities to the Russian market is disclosure of information on securities and issuers.

At present, Russian regulations are more restrictive in respect of trading in foreign securities compared with Kazakhstani regulations.

One of the major problems that impede introduction of foreign securities to the Russian market is information disclosure. The securities market is essentially a market of information, and its competitiveness directly depends on the speed of disclosure of information on traded instruments and respective issuers. The law requires Russian stock exchanges where foreign securities are traded to ensure the disclosure of this information. FFMS experts believe that the stock exchanges can cope with this task by themselves (Medvedeva, Filimoshin, 2010). To date, however, one cannot say that full disclosure of information on corporate events is being achieved.

Under Kazakh law, non-residents cannot issue shares. Placement of non-residents' securities issued under Kazakh law or in other jurisdictions, including Russia, is subject to licensing.

Issuance of securities abroad

This section poses the biggest number of impediments to the integration of the stock market legal framework and legislation in both Russia and Kazakhstan. Under Kazakh law, residents are permitted to issue securities abroad and place them with non-residents only if their previously issued equity securities are listed on a stock exchange in Kazakhstan. In addition, placement of securities with non-residents must be registered as currency transactions related to foreign investments by residents.

³ FFMS' Order no. 10–29 dated April 27, 2010. On Approval of Criteria and Procedure for Inclusion of Foreign Stock Exchanges Whose Listing Is Compulsory for Issuing Permits by Russian Stock Exchanges for Trading in Foreign Securities without a Permit from the Federal Executive Body in Charge of the Securities Market for Public Placement and/or Trading in Such Securities in the Russian Federation. Vestnik FSFR. 2010. no. 7

So far, no issuances or public placements of foreign securities have taken place on the Russian market, but Russian and Kazakh laws provide for these transactions. At present, the Russian regulations are more restrictive in respect of trading in foreign securities than the Kazakhstani regulations.

1.3. International treaties and their role in the development of stock markets

Russia and Kazakhstan are both members of various integration groups. The most efficient vehicle to address the issues of financial markets integration could be the EurAsEC. In 2004 its members entered into an agreement on cooperation in the banking sector (EurAsEC, 2004), which provides, *inter alia*, for the creation of an interstate securities market.

The parties to this document undertook to adopt measures to:

1) harmonise laws regulating:

- the issuance of securities;
- the placement of, and trading in residents' securities in other countries;
- the placement of, and trading in non-residents' securities;
- the activities of professional securities and mutual investments market players⁴;
- disclosure on the securities market;

and set forth:

- the qualification requirements for professional securities and mutual investments market players; and
- the requirements for transactions on the securities market;

2) harmonise the corporate codes of conduct;

3) develop common approaches to control over the securities market.

To date, the financial markets of all EurAsEC countries can be classified as «developing». Thus, according to a World Economic Forum report (WEF, 2009), in 2008 the volume of trade on the stock markets of Russia and Kazakhstan (the group's leading economies) totalled 58.45 and 8.57% of GDP, respectively (compare this to 443.57% in Hong Kong, the absolute leader in this respect). The other EurAsEC countries lag far behind the leaders in banking sector development, which makes the initiative to create a common stock market a long-term plan. Therefore, it seems reasonable to first promote interaction between the Russian and Kazakhstani markets with subsequent inclusion of other EurAsEC members and Ukraine – a country which has extensive economic ties with this community.

It should be admitted at this point that the integration of the securities markets within EurAsEC is still at an initial stage. This statement is best illustrated by the fact that so far the regulatory bodies of Russia and Kazakhstan have no memoranda on understanding or information exchange. Furthermore, KASE is even absent from the above-mentioned list of foreign stock exchanges whose listing is compulsory for a Russian stock exchange to issue a permit for trading in foreign securities without a permit from the FFMS.

An important step towards an efficient corpus of international documents aimed at furthering capital markets development in Russia, Kazakhstan, Ukraine and Belarus would

⁴ Mutual investments market players are investment funds, nongovernment pension funds, management companies, special depositories of investment funds and nongovernment pension funds, and other organisations defined as such in national laws

1. Current status: mutual penetration of stock markets and infrastructure

be to resume the work on the draft Agreement On Adoption of International Standards of Settlement under Transactions in Securities and Derivatives which was halted in 2005 following the refusal by Ukraine's former leadership to participate in the effort to create the Single Economic Area (SEA). This draft contained provisions on harmonisation of laws regulating settlement on securities markets; registration and keeping of securities, including the structure and organisation of national registration systems; depository registration; interaction between registration and clearing organisations; and settlement under transactions in securities, including cross-border settlement.

Article 9 of the draft Agreement set forth the following principles of settlement:

«The Parties believe that settlement orders under transactions in securities on the regulated market must be carried out not later than the next business day following receipt of these orders by a depository organisation or a registrar, unless a later date is indicated in the order.

The Parties understand that efficient settlement can only be achieved by a full switch to electronic messaging in recognised international formats and automation of message processing».

We believe that these principles remain relevant, although in 2008 the EurAsEC Integration Committee made an attempt to draft an agreement on creating the conditions for free capital movement on financial markets.

2. Needs and preferences of Russian and Kazakhstani stock market professional players

- Studying the needs and preferences of market players from both countries in respect of mutual capital market penetration provides a basis for legal and organisational adjustment of the regulatory systems and infrastructure of the financial markets.
- The results of the survey (pages 23–32) confirm the conclusions of our comparative analysis of laws regulating financial markets.

The preparation for this report was accompanied by a survey of professional market players from Russia and Kazakhstan. The main purpose of the survey was to study the opinions of various organisations concerning their plans and preferences in respect of mutual market access, adequacy of mechanisms available for that, and existing problems and impediments. Apart from general questions the survey also included sections on investments in the other country's securities market, placement, and cooperation between Russian and Kazakhstani stock exchanges. The questions were selected so as to cover a maximum circle of respondents of various specialisations. The results of the survey confirm the conclusions on the prospects for integration of two countries' financial markets.

2.1. Survey of professional stock market players from Russia and Kazakhstan

Kazakhstan: categories and specialisation of stock market players

The majority of Kazakhstani respondents who took part in the survey were professional market players (82%).

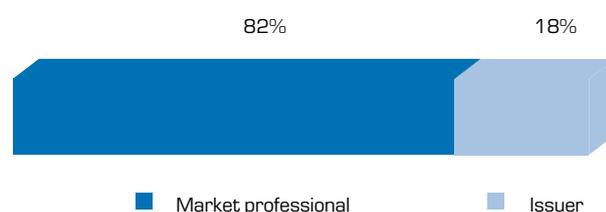


Figure 2.1.
Categories of Kazakhstani respondents

The structure of specialisation of Kazakhstani respondents indicates that many of them engage in multiple professional activities provided for by Kazakh law (see Figure 2.2). The most frequent combination (about 17%) is dealer/broker services plus investment portfolio management. The respondents typically engage in numerous activities, which illustrates the flexibility of Kazakh law in this respect. From the point of view of prospective interaction, Russian investors and professional market players will have sufficient choice to select partners with the required functions in Kazakhstan.

The most popular specialisation on the Kazakhstani stock market is broker/dealer business and investment portfolio management (see Figure 2.3). The structure of licences issued by FSA confirms this conclusion (see Table 2.1).

2. Needs and preferences of Russian and Kazakhstani stock market professional players

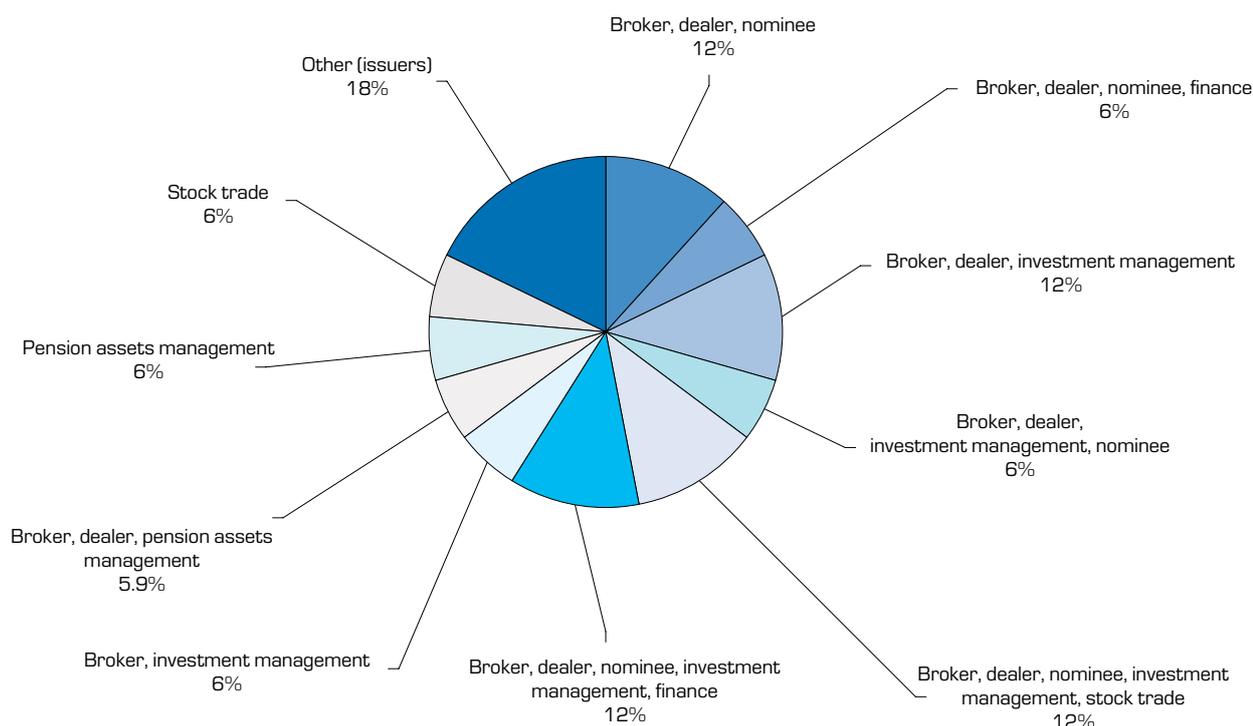


Figure 2.2.
Specialisation of
Kazakhstani respondents

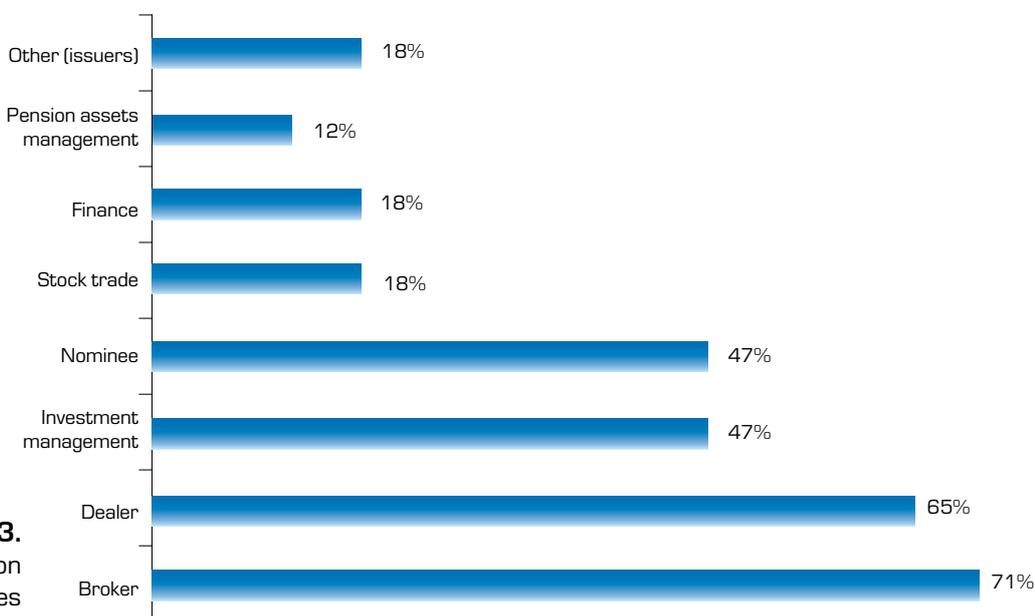


Figure 2.3.
The most common
professional activities

Kazakhstan: investments on the Russian securities market

18% of the respondents have subsidiaries in Russia (see Figure 2.4), and 29% hold Russian securities. Taking into account that 11.8% of the respondents skipped to answer the question on ownership of Russian securities, we can assume that the number might be larger (perhaps about 35%). This indicates that holding foreign instruments is easier than establishing subsidiaries in the neighbouring state. In any case, given the fact that the Russian securities market is well developed and offers higher liquidity compared to the Kazakhstani market, the number of Kazakh holders of Russian securities is likely to be greater.

2. Needs and preferences of Russian and Kazakhstani stock market professional players

Professional players	As at 01.01.07	As at 01.01.08	As at 01.01.09
Brokers and/or dealers	69	87	84
Brokers from the Regional Financial Centre of Almaty	1	19	20
Registrars	17	17	15
Custodians	9	10	11
Pension asset managers	13	11	13
Investment portfolio managers	37	61	66
Self-regulating organisations	2	2	2
Transfer agents	2	3	4
Depositories	1	1	1
Trade organisers	1	1	1
Total	152	212	217

Table 2.1. Number of organisations by professional activities on the Kazakhstani securities market

Source: FSA (2009)

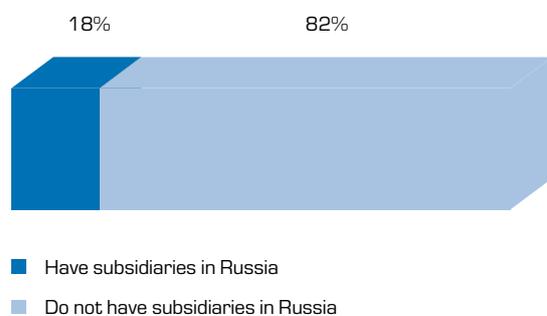


Figure 2.4. Subsidiaries in Russia

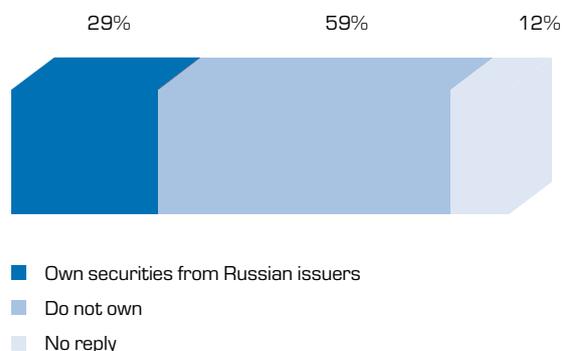


Figure 2.5. Kazakhstani respondents holding Russian securities

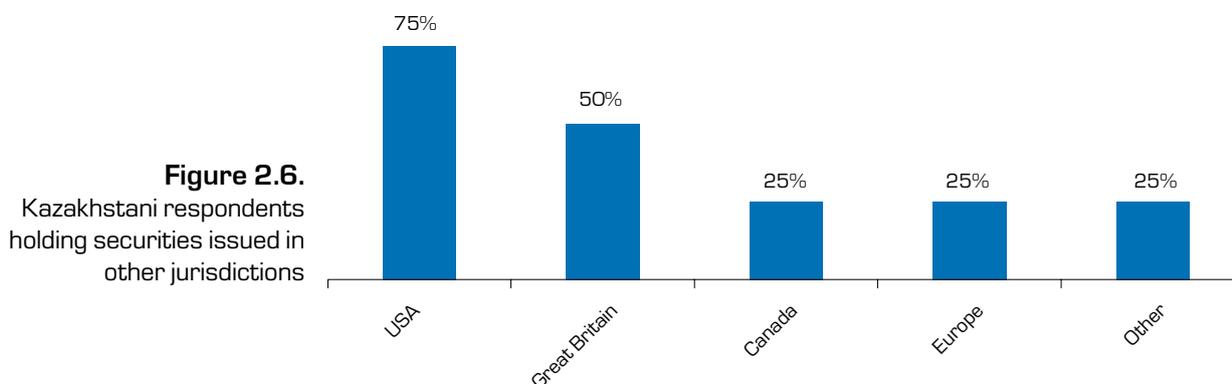
The data allows us to conclude that Kazakhstani professional market players maintain a presence on the Russian securities market.

Most of the organisations that already hold Russian securities intended to buy more in the following six months (the survey was conducted in April–May 2010). Of those who do not hold Russian securities, over 30% intend to buy them. These data are illustrative of relative attractiveness of the Russian market to Kazakhstani professional players.

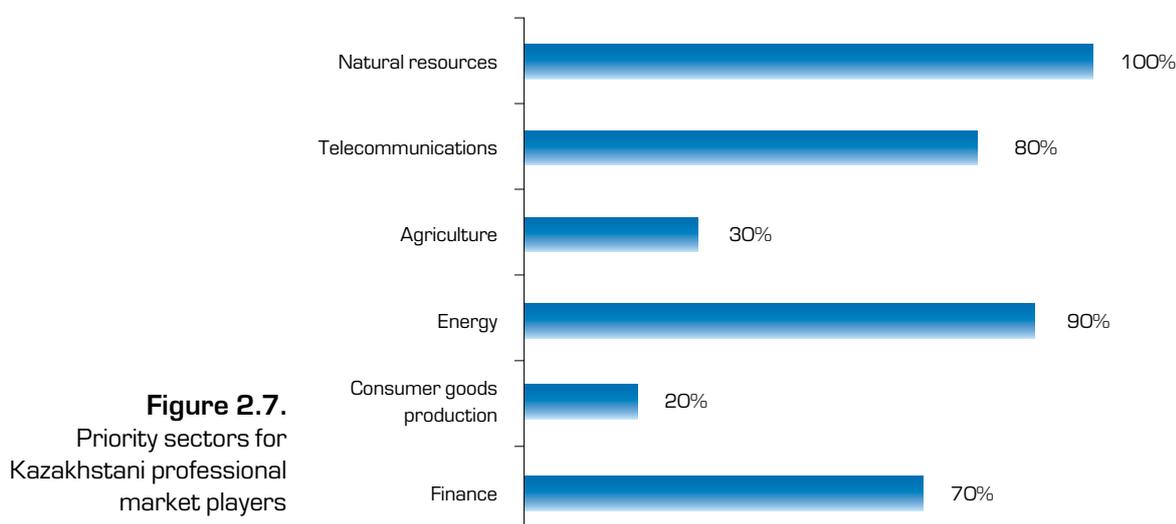
25% of Kazakhstani respondents hold securities from foreign issuers other than Russian. They commented that these countries have highly developed and diverse stock markets capable of satisfying the needs of both the issuer and the investor. These markets offer high liquidity and are well regulated.

The respondents indicated that they had acquired Russian securities on international stock exchanges in the form of GDR or ADR and not directly from the Russian stock exchanges.

2. Needs and preferences of Russian and Kazakhstani stock market professional players



Kazakhstani professional market players are interested in securities issued by the following sectors (see Figure 2.7):



All respondents who answered this question uniformly mentioned natural resources. Many of them also mentioned energy. Telecommunications and finance are also attractive to Kazakhstani players.

As mentioned above, 29% (or, we presume, 35%) of Kazakhstani respondents hold Russian securities. Of this number, over 85% is represented in the registers by depositories, and only 14% is represented directly. Of those represented in registers by nominal holders, equal numbers of respondents preferred the services of depositories and Russian custodians. One respondent works with a licensed Russian subsidiary of a Western custodian.

Kazakhstan: quality of services of Russian registrars

Over 70% of the respondents indicated their satisfaction with the services of Russian registrars. The respondents were asked to evaluate the quality of services by price, speed, convenience, additional services, and uninterrupted service, on a five-grade scale (5 is the highest mark). The respondents gave high marks to practically all of these components. 80% are satisfied with the speed of service and 60% are satisfied with prices. Marks for convenience, additional services and uninterrupted service were uniformly high.

Most respondents who were dissatisfied with the quality of services mentioned the high cost of depository services. One respondent (represented in a register by a depository) mentioned inadequate information exchange with the depository.

64% of those who answered the question on the desirability of direct interaction with Russian registrars by electronic document management systems using digital signatures expressed their wish to use this type of system.

Kazakhstan: problems of interaction with Russian financial institutions

Answering the question on problems with interaction with Russian financial institutions, including registrars, most Kazakhstani respondents mentioned the legal restrictions on double nominal holding:

The impossibility of double nominal holding of Russian securities impedes direct investments in Russia by Kazakh investors
The absence of a central depository in Russia
Kazakh law restricts the activities of financial institutions outside Kazakhstan
Legal restrictions on opening accounts with foreign custodian banks, e.g. Russian banks
Kazakh and Russian laws make it impossible to buy Russian securities on MICEX and RTS, since under Russian law securities must be kept by a Russian depository, and under Kazakh law the securities must be registered with a local custodian. At the same time, Kazakhstani custodians and depositories cannot open accounts with Russian depositories. This complicates access to MICEX and RTS
One of the most urgent problems is associated with the nominal holding of Russian securities by foreign brokers and the need for a mechanism of confirmation of title of beneficial owners. This issue has been voiced at the Association of Financiers of Kazakhstan (AFK). If this issue is resolved, Kazakh investors who hold Russian securities will be able to exercise their right to receive issuer information (on shares and depository receipts representing the shares) and other rights attached to securities, and therefore will be able to protect their interests more efficiently
The most serious problem for Kazakhstani players who enter foreign markets as brokers is that Kazakh law restricts the opening of accounts with foreign custodians. This issue has been debated for many years, but to no avail. This issue is now being addressed by the Association of Financiers of Kazakhstan, and working groups are being created to this end from time to time. Unfortunately, the FSA does not seem to be interested to address this problem

Table 2.2. Problems of interaction with Russian financial institutions

Kazakhstan: placement of securities in Russia

As for the prospects for the introduction of Kazakhstani securities to the Russian market, only 12% of the respondents who answered this question are considering the opportunities (see Figure 2.8). 29% of the respondents did not answer this question.

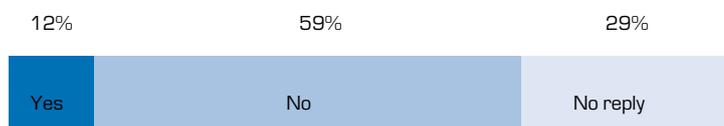


Figure 2.8. Interest in introducing securities to Russia

As for the issuance of RDR, 88% of the respondents indicated that they have no interest in this instrument, and 12% did not answer this question.

The question on preferred methods of introducing Kazakhstani securities to the Russian stock market was answered as follows: issuance of RDR (12%); direct trading (12%); and creating conditions for the settlement of Russian securities in Euroclear and Clearstream (6%). 70% of the respondents did not answer this question.

The above data allows us to conclude that at present Kazakhstani professional players are not keen to introduce their securities to the Russian market. As a consequence, the problem of selecting professional Russian mediators for the introduction of Kazakhstani securities is not

2. Needs and preferences of Russian and Kazakhstani stock market professional players

urgent at present. As there have not been any RDR issuances, Kazakhstani market players have difficulty in assessing their prospects for the use of this mechanism. Direct trading on the Russian stock market is naturally restricted by the stringent requirements imposed by Russian law.

Kazakhstan: proposals on cooperation

Kazakhstani respondents suggested the following forms of cooperation:

Joint efforts to harmonise the laws of two countries. Consultations on strategic development, PR and marketing. Exchange of information. Studying each other's IT infrastructure and trading and clearing tools. Cooperation in developing IT solutions for the Kazakhstani derivatives market
Opening Central Depository's accounts with Russian depositories and vice versa, for the purposes of registering and transferring Russian and Kazakhstani securities
Simplifying the procedure of joint listing on Russian and Kazakhstani stock exchanges
Developing legal frameworks for short sale: legal solution plus technical support. IT infrastructure for the organising of trades in Kazakhstan
Cooperation in developing stock exchange infrastructure using advanced technology. Developing the derivatives market
Double listing
Integration of custodian systems in order to eliminate barriers to Kazakh investor's activity in Russia and vice versa (as an alternative to integrating both markets into Euroclear)
Creating conditions under which attracting portfolio investments by Kazakhstani and Russian organisations would be easier and cheaper than it is on Western markets
Cooperation prospects depend on infrastructural interaction between two stock markets

Table 2.3.

Possible forms of cooperation

Russia: categories and specialisations of stock market players

In contrast to Kazakhstani respondents, nearly half of all Russian respondents were issuers. All of these issuers are professional stock market players. All responding organisations engage in multiple activities and offer integrated services to their clients.

Russian respondents can be divided into the following groups by type of activity (see Figure 2.9).

The most popular activity permitted by Russian law is depository services (82%). Other frequently mentioned activities are broker and dealer services (73%) and trust management (45%).

Russia: investments on the Kazakhstani securities market

In contrast to Kazakhstani organisations, Russian respondents maintain a stronger presence in the neighbouring capital market: some of them hold Kazakhstani securities (see Figure 2.10) and, at the same time, have affiliates in Kazakhstan (50%).

82% of Russian respondents do not intend to buy Kazakhstani securities in the next six months. Typically, Russian businesses view Kazakhstan as a source of natural resources and are reluctant to invest (or organise investing) in other sectors of the Kazakh economy. However, there is a degree of interest in the Kazakh financial sector. We can conclude that currently Russian professional securities market players do not consider Kazakhstan as a target for placement.

46% of the respondents hold Kazakhstani securities. Of this figure, over 36% is represented in registers by the Central Depository and 18% are represented directly. The remaining

2. Needs and preferences of Russian and Kazakhstani stock market professional players

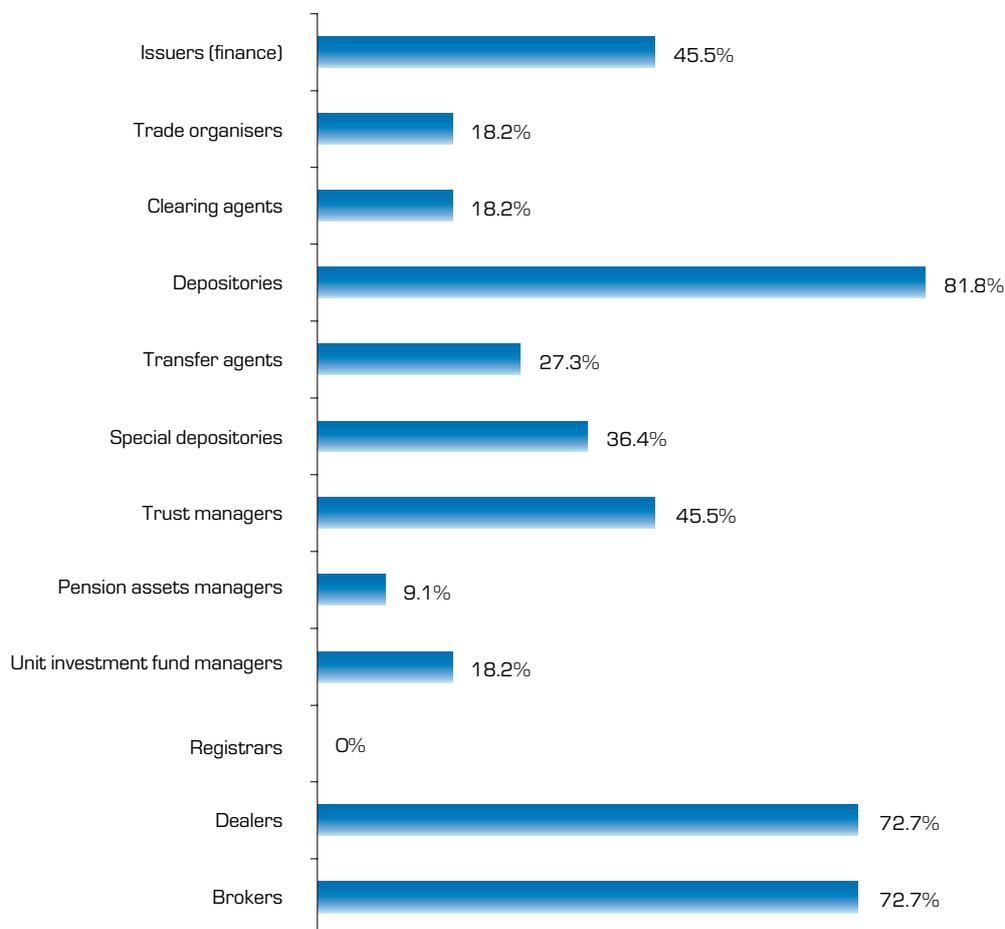


Figure 2.9.
Specialisations of
Russian respondents



Figure 2.10.
Russian respondents holding
Kazakhstani securities

percentage is represented by either licensed Kazakh affiliates of Western custodians or licensed Kazakh affiliates of Russian banks.

Russia: quality of services of Kazakhstani registrars

Over 70% of the respondents indicated their satisfaction with the services of Kazakhstani registrars. The respondents were asked to evaluate the quality of services by price, speed, convenience, additional services, and uninterrupted service, on a five-grade scale (5 is the highest mark). Marks for all these components were uniformly high. Some respondents mentioned the high cost for the services of the Kazakh affiliate of a Western custodian.

Russia: placement of securities in Kazakhstan

Most Russian respondents have no plans to introduce their securities to the Kazakhstani market. However, theoretically they would prefer direct trading on the Kazakhstani stock market (18%) as a method of introduction. This would enable them to avail themselves of the Central Depository services. This method of entering the Kazakhstani market is preferred

2. Needs and preferences of Russian and Kazakhstani stock market professional players

because of its transparency and the exclusion of excessive mediators' fees. To date, Russian respondents show no interest in issuing KDR representing Russian securities.

Russia: problems of interaction with Kazakhstani financial institutions

Russian respondents mentioned the following problems of interaction with Kazakhstani financial institutions, e.g. registrars:

Table 2.4.
Problems of interaction
with Kazakhstani financial
institutions

Absence of a full electronic document management system (SWIFT or similar) for interaction with the Central Depository.
Requirement to disclose beneficiary owner information as at the registration date within 24 hours ⁵ .
Unclear regulations regarding depositing Russian securities with the Central Depository, Kazakhstani custodians and Russian depositories.

Potential sources of mutual portfolio investments

Theoretically, the resources of private pension funds or management companies can be viewed as potential sources of Russian portfolio investments in Kazakhstani securities. In accordance with the Federal Law no. 111-FZ dated July 24, 2002 (version of December 27, 2009), *On Investing for Financing the Funded Part of Pensions in the Russian Federation*, pension savings can be invested in:

- Russian federal government securities;
- bonds of Russian issuers;
- shares of Russian joint-stock companies;
- units (shares) of index investment funds which invest in foreign government securities, bonds and shares;
- mortgage-backed securities issued under Russian law;
- moneys in roubles deposited with credit organisations;
- deposits in roubles or foreign currency with credit organisations;
- foreign currency on accounts opened with credit organisations; or
- securities of international financial organisations permitted for placement and/or public trading in Russia in accordance with the Russian securities law.

To use these opportunities provided by Russian law, unitised investment funds holding Kazakhstani securities must be created. This is unlikely to happen in the near future, at least until the Kazakhstani capital market recovers from the global crisis and/or Kazakhstani securities are traded on the Russian market which offers adequate liquidity. An integrated currency market capable of supporting mutual convertibility of national currencies must be

⁵ Information on the beneficiary owner as at the registration date must be disclosed by a custodian within 24 hours, otherwise the client of the Russian professional player will not be eligible for the application of conventions on elimination of double taxation of securities which are not listed on the stock exchange (i.e. those taxed at a rate of 15%). Disclosure in such a short time span is not feasible because the procedure involves too many mediators. Not only banks but also their clients can act as nominal holders, i.e. within 24 hours the information received from a custodian in Kazakhstan must be delivered to the beneficiary owner (custodian in Kazakhstan – bank – bank's client – nominal holder – beneficiary owner), and then beneficiary owner information must be sent back to the Central Depository. In other words, the only option for clients is to disclose beneficiary owner information in advance, so as to eliminate the need for a custodian in Kazakhstan to request this information from a Russian professional player. This approach leads to the need to open several accounts with a custodian in Kazakhstan for registering the assets of clients/nominal holders who have several clients, hence increased account maintenance costs for these clients.

created within the CIS/EurAsEC framework; otherwise Russian professional players will have no incentive to deposit funds in tenge. This issue is discussed in more detail in *Section 4*.

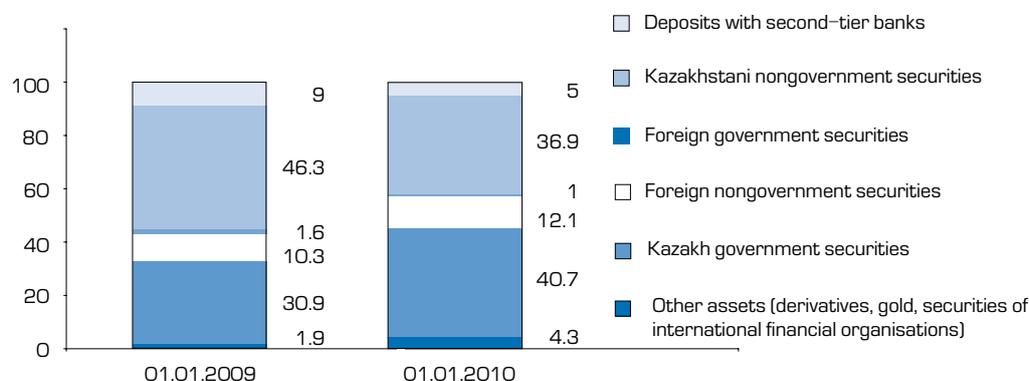


Figure 2.11.

APF asset structure in Kazakhstan

Kazakhstani accumulative pension funds are active on the financial markets of Kazakhstan and other countries, and are important sources of long-term finance for the respective economies (FSA, 2009) (see Figure 2.9).

APF were established in the course of pension reform pursuant to the law On Pensions in the Republic of Kazakhstan (RK, 1997). In the last year alone their assets increased by 31% and totalled 1,860.5 billion tenge by the beginning of 2010 (FSA, 2009). They invest in foreign securities, including Russian securities, (see Figure 2.11), but this trend is likely to change in the near future. According to the above FSA report, at present the strategy of investing pension assets has been adjusted to favour Kazakh government securities (as a measure to ease domestic budgetary problems), and investment in foreign securities reduced as a consequence of this.

No significant Kazakhstani pension fund investments in Russian securities should be expected in the near future.

2.2. Main conclusions on the survey

Our research revealed that Kazakhstani players are interested in the Russian financial market principally as a source of financial resources. By contrast, Russian businesses view the Kazakhstani capital market as a springboard to Kazakhstan's natural resources. Most Kazakhstani organisations are keen to have their securities traded on the Russian market, whereas their Russian counterparts are not interested in the Kazakhstani market in this way. Russian stock exchanges show a degree of interest in cooperation with Kazakh partners and are prepared to list Kazakh instruments.

1. Most Kazakhstani respondents (about 17%) combine their broker/dealer business with investment portfolio management. Other combinations of professional activities vary from 6 to 12%, which illustrates the flexibility of Kazakh law. This leaves Russian investors and professional market players with plenty of choice of partners with the required functions in Kazakhstan.

2. Kazakhstani respondents who have affiliates in Russia (mostly banking structures, 17.6%), are approximately half as many as those who hold Russian securities (29.4%). 25% of Kazakhstani respondents hold securities issued by other jurisdictions.

3. In contrast to Kazakhstani organisations, Russian respondents maintain a stronger presence in the neighbouring capital market: some of them hold Kazakhstani securities and, at the same time, have affiliates in Kazakhstan.

2. Needs and preferences of Russian and Kazakhstani stock market professional players

4. The Russian capital market is attractive to Kazakhstani professional market players. Most of the Kazakhstani organisations that already hold Russian securities intend to buy more in the next six months. Over 30% of the respondents intend to buy Russian securities for the first time.

5. 29% (or, we assume, 35%) of Kazakhstani respondents hold Russian securities. Of this number, over 85% is represented in registers by depositories, and only 14% is represented directly. Of those represented in registers by nominal holders, equal numbers preferred the services of depositories and Russian custodians.

6. The respondents show no interest in issuing KDR representing Russian securities – probably because these securities can be acquired directly.

7. 60% of the respondents expressed their wish to use electronic document management systems for interaction with Russian registrars.

8. Kazakhstani respondents mentioned the issuance of RDR, direct trading and creating conditions for settlement on Russian securities in Euroclear and Clearstream as their preferred methods for the introduction of Kazakhstani securities to the Russian stock market.

9. At present Kazakhstani professional players are not keen to introduce their securities to the Russian market, and so, to date, the problem of selecting professional Russian mediators for the introduction is not an urgent one. As there have been no RDR issuances, Kazakhstani market players have difficulty assessing their prospects for the use of this mechanism. Direct trading on the Russian stock market is naturally restricted by the stringent requirements imposed by Russian law.

10. Most Russian respondents have no plans to introduce their securities to the Kazakhstani market. However, theoretically, they would prefer direct trading on the Kazakhstani stock market (18%) as a method of introducing their securities. This would enable them to avail themselves of the Central Depository services. This method of entering the Kazakhstani market is preferred because of its transparency and the exclusion of excessive mediators' fees.

11. Kazakhstani players are interested in Russian financial market principally as a source of financial resources. By contrast, Russian businesses view Kazakhstani capital market as a springboard to Kazakhstan's natural resources. As a consequence, most Kazakhstani organisations are keen to have their securities traded on the Russian market, whereas their Russian counterparts are not interested in the Kazakhstani market in this way. However, Russian stock exchanges show a degree of interest in cooperation with Kazakh partners and are prepared to list Kazakh instruments.

12. Financial resources controlled by private pension funds or management companies can be viewed as a potential source of Russian portfolio investments in Kazakhstani securities. However, in order to make use of the opportunities provided by Russian law, unitised investment funds holding Kazakhstani securities must be created. This is unlikely to happen in the near future, at least until the Kazakhstani capital market recovers from the global crisis and/or Kazakhstani securities are traded on the Russian market which offers adequate liquidity.

13. Accumulative pension funds are active players on the financial markets of Kazakhstan and other countries. However, they should not be expected to make any significant investments abroad, particularly, in Russian securities. At present they are changing their investment strategy in favour of increasing their holdings of Kazakh government securities and cutting down investments in foreign securities.

14. Our survey covered Russia's main stock exchanges (RTS and MICEX) and their Kazakh counterpart KASE. RTS ranks highest among them in terms of investments in the other country. To date, only RTS has a subsidiary in Kazakhstan (Commodity Stock Exchange ETS) and holds Kazakhstani securities.

3. Approaches to stock market regulation

- The issues of stock market development in Russia and Kazakhstan are closely interrelated with the issues of recovery from the global financial crisis.
- Kazakhstan's need for foreign investments is being addressed through prompt regulatory measures targeting financial institutions that meet this need on the domestic capital market.
- Whilst the Russian economy faces urgent problems of post-crisis recovery, no long-term financial market development policy is in place.

The analytical paper *On the Status and Development Trends of the Securities Market in CIS Member States* (CIS Executive Committee, 2009) concludes that the liquidity crisis and instability of international financial markets affected post-Soviet economies, including security markets. In 2008 the growth in the number of domestic issuers and capitalisation on the most developed CIS stock markets gave way to a decline in stock indices and market capitalisation levels of issuers, especially those whose instruments were traded internationally. The crisis highlighted the main problems and weaknesses of financial market regulation. A drop in liquidity of domestic stock markets and the market value of traded instruments and a rise in defaults by issuers on the organised CIS markets allowed the main areas of concern in the regulatory system to be identified: the protection of investors' rights and interests, maintaining the financial stability of issuers and professional securities market players, fair evaluation of instruments available for investment, as well as assessment and management of investment and operating risks.

The global crisis seriously affected the economic situation in Kazakhstan, and the Government started adopting measures to maintain the financial stability of the stock market (RK, 2003b). In particular, the mandatory charter capital size for market players was raised; this indirectly pushed Kazakhstani financial institutions into shareholding in foreign, e.g. Russian, entities. In 2009, in order to increase the financial stability of brokers/dealers who are authorised to maintain clients' accounts as nominal holders and perform certain banking operations, the procedure of equity size calculation and sufficiency ratios were optimised. As a measure to reduce external borrowing, FSA introduced capitalisation ratios for liabilities to non-residents. These are calculated as ratios of various liabilities to the professional player's equity.

Another step towards enhanced financial stability of professional securities market players was the revision by the FSA of a number of regulations which set forth risk management requirements for organisations engaging in dealer and/or broker business or investment portfolio management. As part of this, a double control system (for execution and registration of financial transactions) was introduced; a stress-testing procedure was developed; the maximum permissible loss on client's assets for trust managers was set; and the procedure of making decisions on transactions in the player's own assets was made more elaborate (the requirement to set up an investment committee to this end was added); and internal audit of risk management systems was made compulsory. This comprehensive and modern approach by the Kazakh financial market regulator is in marked contrast to the FFMS' plans to switch to prudential supervision of securities market players. Clearly, Kazakhstan's need for foreign investments is being addressed through prompt regulatory measures targeting financial institutions.

Kazakhstan's need for foreign investments is being addressed through prompt regulatory measures targeting financial institutions.

3. Approaches to stock market regulation

In Russia, adjustments to financial market regulation are being made in line with the *Strategy of Development of the Financial Market of the Russian Federation until 2020* (RF, 2008), the *Concept of Creating a Global Financial Centre in the Russian Federation* (RF, 2009a) and the *Plan of Action to achieve this* (RF, 2009b). The purpose of these documents is to enhance the stability and competitiveness of the Russian financial sector; however, they were all prepared in 2008–2009. The Plan outlines the legal steps to create an international financial centre (IFC); these measures may appear to be instrumental in reaching this goal, but they are essential for normal operation of any market even if it does not attain IFC status. For example, the formulation of the objective to «create a compensation system on the financial market» contains no direct indications as to the content, cost or effects of the required system. This objective is assigned to a group of agencies: the FFMS, the Ministry of Economic Development, the Ministry of Finance and the Central Bank, which in itself gives rise to doubts about their ability to properly coordinate this effort. Even if all the measures named in the IFC Concept and Strategy are implemented, Moscow will not automatically turn into an IFC comparable with the world's top ten (Moscow and St. Petersburg currently rank 68th and 70th, respectively).

The progress of the Russian stock market on its way towards an IFC was slowed down not only (and not essentially) by the crisis, but also by the inefficient regulatory system.

What the FFMS really should do in order to accelerate the formation of an IFC is to provide a regulatory framework for trading in foreign securities in Russia.

Notably, the IFC Concept and Strategy were developed before and during the 2008 financial crisis. However, the progress of the Russian stock market on its way towards an IFC was slowed not only (and not critically) by the crisis, but also by the inefficient regulatory system.

Currently, the world's largest financial centres, including the US and the UK, are revising their approaches to regulation, trying to draw lessons from the crisis. Russia's main partner in EurAsEC and the Customs Union, Kazakhstan, also responded quickly to the challenge. In February the President of Kazakhstan approved the *Concept of Development of the Financial Sector of the Republic of Kazakhstan in the Post-Crisis Period* (RK, 2010). This document defines the ultimate goal as «the development of the financial sector in the post-crisis period, particularly, elevating it to a new qualitative level of management and regulation».

The Concept provides that regulation and supervision of the financial sector will be based on the counter-cyclical policy principle (i.e. formation of reserves and increasing equity capital and liquidity during periods of economic upsurge so that to use this accumulated potential during recession). The same principle applies to the structure and quality of investment portfolios of financial organisations. The document stresses the importance of getting rid of pro-cyclic approaches in regulation. Notably, similar Russian documents do not seem to contain any underlying principle at all.

The Kazakhstani Concept includes five sections addressing the key aspects of the functioning of the financial market:

- 1) definition of the state's role in mobilising financial resources;
- 2) strengthening the regulatory and supervisory systems;
- 3) strengthening mechanisms for protecting the rights of investors and consumers of financial services;
- 4) enhancing the quality of corporate governance and transparency of financial organisations;
and
- 5) managing systemic risks and interaction between governmental agencies.

The Kazakhstani Concept also addresses the issues of government interference with the economy. The government will assume a more prominent role in planning and stimulating the economy, but the basic principles of free market and free private sector will be preserved. The state will switch from full social support for various population groups to a mixed system where employees will share responsibility for their welfare with employers and the government. As the first step in this direction, a savings pension system was adopted in Kazakhstan; the goals of this pension reform were to reduce public expenditure, and, equally importantly, to create a new class of institutional investors.

Private–public partnership will become the main engine of economic modernisation in Kazakhstan. Accumulative pension funds will be encouraged to invest in infrastructure projects. Individual deposits with second–tier banks are viewed as the main (albeit conservative) potential source of funds for the financial sector. The Concept also places an emphasis on the government securities market; notably, corporate securities are assigned a secondary role, as this segment is still largely underdeveloped. It is envisaged that «the existence of a moderate budgetary deficit and manageable government debt will permit the circulation of an adequate quantity of governmental securities at all times; this quantity will be instrumental in drawing a yield curve, defining short and longer term expectations, assessing the risks to which financial instruments are exposed, and determining spot rates for prospective borrowings».

Private–public partnership will become the main engine of economic modernisation in Kazakhstan. Accumulative pension funds will be encouraged to invest in infrastructure projects. Individual and corporate deposits with second–tier banks are viewed as the main potential source of funds for the financial sector. Islamic financing will also be developed as an additional source of funding.

The Kazakhstani Concept states that the volume of medium and long–term government securities (issued in order to cover the budgetary deficit) must be determined by the capacity of the domestic securities market. Alternative sources of savings, such as private institutions, real estate funds and hedge funds, will also be widely employed.

Islamic financing is also named as an additional source of funds. The conditions necessary for the establishment of Islamic banks and investment funds and issuing Islamic instruments were created by amendments to the respective laws made in February 2009 (RK, 2009). In contrast, Islamic financing is not even mentioned in the IFC Concept and Strategy of Russia, a country with a multimillion Muslim community. Regulation and supervision of Islamic financial organisations in Kazakhstan will be the responsibility of the FSA. The main platform for the development of the Islamic instruments market will be the Agency for Regulation of the Regional Financial Centre of Almaty (the RFCA Agency). This distribution of responsibilities reflects the somewhat dual nature of the Kazakh regulatory system, which first manifested itself following creation of the RFCA Agency pursuant to Law no. 145, *On the Regional Financial Centre of Almaty*; thus, the short–lived integrity of the regulatory powers of the FSA was to some extent weakened. The RFCA Agency is authorised to:

- approve the rules for state registration (re–registration) of entities that are participants in RFCA;
- approve the rules of accreditation of participants in RFCA;
- set requirements for issuers whose securities are proposed for listing or listed on the special trading floor of RFCA, and, jointly with the FSA, requirements for these;
- approve the list of rating agencies whose ratings are recognised by FSA;
- set rating requirements for securities and issuers applicable on the special trading floor of RFCA, etc.

The authors of the Kazakhstani Concept paid close attention to strengthening the regulation and supervision of the financial market. It is stressed that integrated control can exclude

3. Approaches to stock market regulation

conflicts of interests which are inevitable under functional or institutional supervision systems. In other words, all Kazakhstani financial institutions will remain accountable only to FSA, although the RFCA Agency is vested with some law-making powers which overlap those of FSA. The Chairman of the RFCA Agency is a member of the FSA Board; this body, for example, controls KASE, whose largest shareholder (12.26%) is RFCA. This overlapping power and responsibility has the potential to generate conflicts of interests.

In Russia, the same financial institutions are regulated and supervised by the FFMS, the Central Bank, the Federal Financial Monitoring Service, the Ministry of Finance and Social Development, and others.

The current regulatory system of the Russian capital market is cumbersome and overly complex compared to the Kazakhstani system. The above mentioned Russian documents also contain provisions on modernisation of financial market regulation, but these are essentially general statements. It is recognised that the current intention is not to create a consolidated regulatory body, but to improve the coordination of the existing ones. To this end, it was proposed that interministry coordinating structures such as the Presidential Council on Development of the Financial Market (actually established in 2009) and an IFC working group attached to it be created. The Strategy recognises the need to switch from the principles of industry-specific (functional) regulation to state-level regulation of financial market risks (threats to financial stability, unscrupulous activities and violation of the rights of investors and market players). However, even the crisis did not push the Russian regulatory bodies into practical action in this sphere.

In contrast, the Kazakhstani regulatory system made significant progress in this respect. In line with the Kazakhstani Concept, the supervisory body will impose additional requirements for financial organisations concerning transparency of decision-making on foreign investments and lending. This will allow the risk of transactions with countries exposed to high legal risks and inadequate protection of the rights of investors and lenders to be reduced.

The Russian Concept stresses the inefficiency of industry-specific banks, as these institutions cannot function properly in a competitive environment and need government support. The Russian financial market (and, first of all, the banking sector) is dominated by structures with heavy government shareholding, and their role as recipients of government resources intended for maintaining the liquidity of the financial system was boosted even further by the crisis.

The message of the Kazakhstani Concept is that government support for the financial market must be gradually reduced. Thus, the government intends to reduce its interference with all market segments and fully withdraw when an adequate level of fair competition is achieved.

The message of the Kazakhstani Concept is that government support for the financial market must be gradually reduced. The Russian documents do not contain any indications of the government's forthcoming withdrawal from the market, e.g. the Central Bank's withdrawal from the capital and management of MICEX. However, the reductions of government shareholdings in Sberbank and VTB are planned for 2011–2013.

Notably, the Russian documents do not contain any indications of the government's forthcoming withdrawal from the market, e.g. the Central Bank's withdrawal from the capital and management of MICEX. However, the possibility of reducing government shareholding in Sberbank and VTB has recently been voiced.

The Kazakhstani Concept envisages that foreign participation in the financial sector will be limited to 50% of total equity capital. The Russian documents do not address this issue, although certain legal barriers to foreign capital in the banking sector do exist.

In order to better protect the interests of investors and consumers of services on the Kazakhstani securities market, the responsibility level of senior management of joint-stock companies will be increased; stricter transaction transparency requirements will be

introduced, corporate governance systems will be improved, and issuer information disclosure will be regulated in more detail.

Corporate governance and transparency of Kazakhstani financial organisations will be enhanced by introducing requirements for internal audit, risk management systems, information disclosure and fair evaluation of financial instruments. The Russian Strategy also addresses these issues and provides for similar measures. The Kazakhstani Concept contains provisions on strengthening macro-prudential supervision, which includes a package of measures for eliminating systemic risks. The purpose of this form of regulation is to identify key solutions on particular activities and markets that are exposed to systemic risks which threaten financial and economic stability.

The Russian Strategy also provides for creating a system of prudential supervision at several levels: internal audit of financial market players, control of self-regulating organisations, and state control by government agencies. The other proposed measures include:

- harmonisation of methods and rules of supervision of professional securities market players and the banking supervision rules;
- adoption of common requirements on calculation of equity capital (consistent with international standards) for all professional securities market players and unit investment fund management companies in parallel with the modernisation and unification of accounting rules applicable to financial organisations;
- revision of requirements for the minimum equity capital size to international standards;
- adoption of requirements for capital sufficiency in view of the organisation's financial risks;
- adoption of advanced risk assessment methods based on internationally recognised models, including ratings and digital indices reflecting operating risks.

The Russian Strategy outlines the principle of proportionality of prudential supervision – that is, supervisory requirements should apply to market players with due regard for their size, type of activity, nature of transactions and related risks. A prudential supervision system should employ an individual approach towards assessing risks to which market players or their assets are exposed. Unfortunately, the current FFMS practice is not consistent with the proportionality approach; a problem which is discussed in more detail below. It should also be noted that, whereas the Kazakhstani Concept upholds the principle of counter-cycle policy, the Russian Strategy and the current practices of Russian regulatory bodies focus principally on stiffening equity capital size requirements for non-banking players, which is being presented as implementing international recommendations, although with no regard for the current phase of the economic cycle. The Kazakhstani regulatory system will employ a new index reflecting recovery of the banking sector – namely, ratio of banking system assets to pre-crisis GDP, although the current structure and quality of the assets are largely different from the pre-crisis pattern.

The development of the Kazakh financial market will follow the principle of counter-cycle policy. The Russian Strategy and the current practices of Russian regulatory bodies focus principally on stiffening equity capital size requirements for non-banking players, although with no regard for the current phase of the economic cycle.

Our comparison of two approaches towards financial market development allows us to conclude that the Kazakhstani Concept is a fairly consistent document which covers both the banking and non-banking segments of the financial market and addresses the problem in a comprehensive and systematic manner. Unlike similar Russian documents, it is more fundamental and conveys a clear message for financial market players and investors as to the prospective changes in state regulation. On the other hand, the Russian documents present merely general statements rather than practical formulae. Whilst the Russian economy is facing the urgent problems of post-crisis recovery, no long-term financial market development policy is in place.

4. Interaction between Russian and Kazakhstani stock exchanges for capital markets development

- Russian and Kazakhstani stock exchanges as main organisers of trade are keen to cooperate with each other.
- During the past decade a great deal of organisational work was done in both countries, however we still cannot say that an adequate level of integration was achieved nor can we say that we are nearing a common stock exchange space.

4.1. Interaction between Russian and Kazakhstani stock exchanges

Stock exchanges are the central elements of a financial infrastructure. Occupying a position between monetary authorities/regulatory bodies and stock market players, they not only organise trade and facilitate settlement, but also serve as a vehicle for change and innovation.

The Russian and Kazakhstani stock exchanges are striving to expand mutual cooperation. It is natural, in view of the fact that MICEX, RTS and KASE are all members of the International Association of Stock Exchanges of the CIS (IASE). The goals of this organisation are (CIS IASE, 2000):

- the formation of a single stock exchange space based on advanced stock trading technology;
- mutual admission of non-resident traders;
- the facilitation of national currency flows between CIS countries;
- the adoption of international securities market standards in CIS countries and mutual recognition of issuance registrations;
- cooperation between CIS members in capital market and single stock exchange space development;
- the development of basic standards for unification of the interbank capital market;
- cooperation in the development of currency and lending transactions on national currency markets;
- the formation of the CIS monetary system based on national currencies;
- practical implementation of the principle of mutual recognition of national currencies and official quotations;
- achievement of mutual convertibility of national currencies for the purposes of current transactions;
- the introduction of mechanisms and instruments for currency, interest and price risk hedging;
- support for floating national currency rates and approval of maximum fluctuations;
- the introduction of a banking mechanism and market makers for the purposes of supporting national currencies and achieving full convertibility of such currencies.

The goals declared by IASE CIS are very challenging, and they are much more precisely formulated than any international agreements in this sphere. Of course, the achievement of these goals does not entirely depend on the stock exchanges themselves, yet the formulation of these goals indicates that the stakeholders wish to cooperate on definite terms. It does not really matter whether this cooperation will be in the CIS, EurAsEC or bilateral format; what is important is that the IASE CIS is in a position to make a positive contribution to this process.

The persisting global crisis hit stock trade hard, especially the trade in securities. Of the 130 companies listed on KASE, 24 defaulted on their debt instruments, and five of these 24 companies defaulted on coupons and the principal. Many companies are more than one coupon period in arrears. These include two largest Kazakh banks, Alliance Bank and BTA Bank, whose indebtedness to bond holders (29.7 billion tenge) accounts for 56% of the total indebtedness on bonds of all defaulting companies.

The Kazakh financial authorities promptly responded to this negative impact on stock trade by revising the securities law in two ways. First, listing requirements for certain categories of instruments and issuers were lowered. This stabilisation measure had been applied in international practice to resolve similar problems, and the FSA decided to learn from this experience. The softening of listing requirements allowed some companies to recover from a financial setback and remain on the official list despite their deteriorated financial performance indicators.

Particularly, amendments were made to FSA Board Resolution no. 77 dated May 26, 2008, *On Requirements for Issuers and Instruments Permitted to Trade on the Stock Exchange and Certain Listing Categories*. The mandatory equity capital size of debt securities issuers was reduced, the requirement to employ a market maker for certain categories of debt securities was lifted, and the profit periods requirement was eased. These amendments to the listing requirements were dictated by the fact that during the crisis many listed Kazakhstani companies suffered losses and, accordingly, their equity capital size shrank.

Second, a special buffer category of securities was added to the official list. It is stated that this measure is aimed at protecting the rights of crisis-stricken issuers: they are given an opportunity to remain on the official list, although with a reduced status. These issuers can continue introducing their instruments to the stock exchange, which, in the opinion of the authorities, is less detrimental from a systemic point of view than delisting.

The above measures undoubtedly played a role in stabilising the Kazakhstani stock market; however, the number and scale of continuing defaults seriously concerned potential Russian

The International Association of Stock Exchanges of the CIS was founded in April 2000 in Moscow in an effort to coordinate the creation of organised financial markets to international standards.

CIS IASE comprises 20 organisations from 10 CIS countries which play the central role in servicing mutual financial flows, currency operations and transactions in government and corporate securities.



Azerbaijan (Baku Interbank Currency Exchange)



Armenia (NASDAQOMX Armenia)



Belarus (Belarusian currency and stock exchange, Belarusian Universal Commodity Exchange)



Georgia (Tbilisi Interbank Currency Exchange)



Kazakhstan (KASE, Central Securities Depository)



Kyrgyzstan (Kyrgyz stock exchange)



Moldova (Moldovan Stock Exchange)



Russia (MICEX, Samara Currency Interbank Exchange, SPCEX, Siberian Interbank Currency Exchange, RTS)



Uzbekistan (UZSE, Uzbek Republican Commodity Exchange)



Ukraine (National Depository of Ukraine, Interbank Currency Exchange of Crimea, Ukrainian Interbank Currency Exchange, PFTS Stock Exchange)

4. Interaction between Russian and Kazakhstani stock exchanges for capital markets development

buyers of Kazakhstani securities, and this sentiment still persists. For comparison: in 2008, 16 Russian bond issuers defaulted on coupon payments on 20 issuances, 21 issuers defaulted on offers on 22 issuances, and 1 issuer defaulted on maturity; in 2009, 50 issuers defaulted on coupon payments on 60 issuances, 41 issuers defaulted on offers on 46 issuances, and 17 issuers defaulted on maturity. Of course, these negative developments do not appear as severe as the Kazakh defaults in the context of the Russian market size: as at September 1, 2009, MICEX traded 578 corporate bond issuances of 409 companies for a total of 2,000 billion roubles and 18 commercial paper issuances of 6 issuers for a total of 58 billion roubles, and had on its list 248 corporate bond issuances (42.5% of the total number) and 4 commercial paper issuances of 3 issuers; in addition, 14 commercial paper issuances were traded in the off-list sector.

During the past decade a great deal of organisational work was done in both countries, however we still cannot say that an adequate level of integration was achieved nor can we say that we are nearing a common stock exchange space. This conclusion is confirmed by the results of our survey which covered RTS and MICEX of Russia and Kazakhstan's main stock exchange KASE.

RTS ranks highest among them in terms of investments in the other country. To date, only RTS has an affiliate in Kazakhstan (Commodity Stock Exchange ETS) and holds Kazakhstani securities.

It should be noted that both RTS and MICEX head vertically integrated financial groups comprising various organisations. This allows a choice of specialised partners for cooperation with Kazakhstan in different aspects of financial markets integration. KASE also has affiliates and dependent business entities in its organisational structure with similar functions and roles.

All these stock exchanges are shareholders of other CIS stock exchanges, and this determines their preferences in cooperation to some extent. For example, RTS is implementing several joint projects with foreign counterparts, and KASE has a 10.6% stake in the Kyrgyz Stock Exchange (unfortunately, in view of the recent events in Kyrgyzstan, this is unlikely to bring about any positive developments in the near future). The intention to cooperate is already there, and this intention takes various practical forms.

During the survey (the results are presented in Section 2) the respondents were asked about prospective forms of cooperation between Russian and Kazakhstani stock exchanges. MICEX provided the most extended answer to this question:

- exchange of information on working plans, stock market development prospects, improvements to trading systems, interaction with clearing, depository and settlement systems, and adoption of new technology and instruments;
- technical cooperation;
- bilateral commercial projects;
- mutual penetration of stock markets by Russian and Kazakhstani players;
- organisation of trade in RDR and KDR;
- direct admission of Kazakhstani issuers to Russian stock exchanges;
- clearing services;
- disclosure of corporate information of Russian and Kazakhstani issuers;
- joint efforts to develop CIS countries' markets under the aegis of IASE CIS;
- participation in CIS and EurAsEC bodies, the Russian–Kazakh Commission on Economic and Financial Issues, etc.

KASE mentioned the following prospective areas of cooperation with Russian counterparts:

- harmonisation of two countries' laws, as a precondition for stock market integration projects;
- consultations on strategic development, PR and marketing;
- exchange of information for the purposes of attracting investors;
- exchange of experience related to IT infrastructure and trading and clearing systems in order to enhance efficiency and quality of services;
- cooperation in developing IT solutions for the Kazakhstani derivatives market.

In the short term, the main focus should be on the integration of the Russian and Kazakhstani stock exchanges as the organisers of the most developed markets in EurAsEC (IASE, 2009). A positive example of integration on the commodity market is the creation of the Eurasian Trading System stock exchange in the end of 2008 by the RFCA (40% of the charter capital) and RTS (60%). Unfortunately, as the crisis persists, to date only the farm produce section is operational, although oil products and metals sections are to be launched. We should also mention the project to create the Eurasian Stock Exchange of Farm Produce, Raw Materials and Foodstuffs which is being developed on the initiative of the EurAsEC Integration Committee, and which effectively competes with the above project. The new stock exchange will be based on the Belarusian Universal Commodity Exchange and is expected to start in 2011. If this project becomes a success, it should be integrated into the ETS through a mechanism suitable for all participants – such as the existing trading floor in Almaty.

Although the main responsibility for simplifying interaction between organised market players from two countries lies with the stock exchanges themselves, not everything depends on them. For example, as we have mentioned above, both the stock exchanges and professional capital market players such as central depositories need an adequate nominal holding mechanism for foreign investors which would fit with the laws of two states, and a developed clearing system including centralised functions.

Another important element of technical integration is the development and introduction of a common electronic document management technology which would allow information exchange between stock exchanges and traders to be standardised and accelerated.

4.2. Preconditions and problems of integrated currency market development

Professional financial market players from Russia and Kazakhstan understand that economic cooperation between these two countries will expand steadily despite the persisting global crisis. The preconditions for an integrated currency market are already there: the experience of interaction and mutual ties between Russian and Kazakh banks, including shareholding, and extensive market infrastructure.

Although currency regulation varies across the CIS and EurAsEC in terms of openness, prior to the crisis there was a clear overall tendency towards liberalisation of currency laws. Generally,

In the short term, the main focus should be on the integration of the Russian and Kazakhstani stock exchanges as the organisers of the most developed markets in EurAsEC.

Effectively, ETS (launched in 2009) and the prospective Eurasian Stock Exchange are competing projects on the farm produce market. They should be integrated, perhaps on the basis of the ETS which is already operational.

Stock exchanges, depositories and other professional capital market players need an adequate nominal holding mechanism for foreign investors which would fit with the laws of two states, and a developed clearing system.

4. Interaction between Russian and Kazakhstani stock exchanges for capital markets development

the currency markets in CIS countries demonstrate positive growth dynamics. The crisis resulted in significant changes in CIS currencies' exchange rates, and companies and the population at large started to show greater interest in currency exchange transactions, hence an increase in currency market turnovers (Mishina, 2009).

However, the volume of transactions in CIS national currencies on the Russian interbank market **remains negligible**⁶. In September 2009 the total volume of currency conversion transactions reached \$52 billion a day. Transactions in the Ukrainian hryvnia and Kazakh tenge totalled \$6 million, and transactions in the Belarusian rouble about \$1 million a day – less than 0.01% of the Russian currency market turnover. Notably, even these small exchange transactions involved the US dollar rather than the Russian rouble.

99% of all transactions on the Kazakh interbank market involve the US dollar. In 2008, stock trade in the US dollar increased by 9.1% to \$66.6 billion. At the same time, trade in the US dollar dropped by 26.4% to \$103.5 billion on the unorganised market. Transactions in the Russian rouble and euro accounted for less than 1% of the total turnover of the organised and unorganised segments of the currency market. On stock exchanges, transactions in the Russian rouble grew by 39.5% to 573.8 million Russian roubles, and euro transactions grew by 3.3% to €11 million. In the unorganised segment, transactions in the Russian rouble dropped by 2.1 times to 1.9 billion Russian roubles, whereas euro transactions grew by 7.5% to €588.5 million (Mishina, 2009).

The reluctance to make payments in CIS national currencies and the use of the US dollar or euro result in higher transaction costs, inconvenience of mutual payments under financial transactions, and the need to maintain additional sums in foreign currencies – hence unnecessary currency risks.

According to IASE CIS, in 2008 the total volume of trade in foreign currency on the member stock exchanges reached \$2.8 trillion – a 78% increase over the previous year's figure. Trade in the Russian rouble in 2008 was especially extensive in Belarus: Russian rouble transactions on the Belarusian Currency Stock Exchange (BCSE) totalled 124.4 billion roubles, accounting for more than 27% of all currency transactions. On KASE, tenge–US dollar transactions account for 99% of all currency transactions and rouble and euro transaction amount to less than 1%. On MICEX, transactions in CIS national currencies are very rare: the last rouble–tenge transaction took place in 2000. Taking the objective of developing an integrated currency market as indicated in the EurAsEC Agreement (EurAsEC, 2006) into account, MICEX started preparing a project to stimulate trade in soft currencies (namely, receiving liquid direct quotations without US dollar mediation). On November 2, 2009 MICEX introduced new rules which grant EurAsEC countries' residents the right to become members of the MICEX currency market section. Banks from EurAsEC countries will be able to participate in «Single Regular Trading» after the respective national (central) banks sign an agreement with the Central Bank of Russia.

An analysis of the soft currencies market shows that its efficiency largely depends on efforts to improve the settlement infrastructure and regulatory support from Russian and Kazakh governmental agencies. The commencement of the Agreement on the Customs Union of Russia, Kazakhstan and Belarus in July 2010 created the conditions for the resumption of talks on adoption of a common currency by these three countries. This step would elevate the stock market integration effort to a new level and have a diverse effect on various economic sectors.

⁶ <http://www.eabr.org>, <http://infoshos.ru>

Conclusions

This study conducted by the Eurasian Development Bank with support from the PARTAD enables an assessment of the prospects and problems of integration of the capital markets of Russia and Kazakhstan. In technical and legal terms, these problems are largely similar to those faced by the capital market integration effort in EurAsEC as a whole. Our analysis of the legal framework for mutual penetration of Russian and Kazakhstani capital in the form of stock market instruments shows that there are no insurmountable barriers to this process. Moreover, the basic legal preconditions for this mutual penetration are all in place. However, as the financial crisis persists and the capital markets of Russia and Kazakhstan fail to function as a single IFC in the global financial market, this mutual penetration is still of little use.

Notably, these two EurAsEC member countries have no explicit political or other barriers to integration of capital markets. This warrants synchronisation of their regulatory systems and infrastructure, which will allow them to quickly and efficiently organise trading in Kazakhstani securities and depositary receipts on Russian exchanges; to secure reliable communication between the holder, the issuer and the registrar by electronic document management systems; and to enable the disclosure of information on these financial instruments at a single EurAsEC centre, irrespective of location, in both Russian and English.

The survey reveals that currently potential issuers and professional players show little interest in the integration of the stock markets of Russia and Kazakhstan and prefer to work on international markets. Thus, competition with other financial centres necessitates significant effort to improve the attractiveness of regional financial solutions and instruments.

Accordingly, the ultimate goal should be defined as a common Eurasian financial centre with infrastructure elements located across EurAsEC and form a single exchange trade, clearing and settlement system. Most of these elements will be concentrated in Russia, due to some significant economic or technical advantages. Nonetheless, other EurAsEC members (primarily, Kazakhstan) will have a role to play in the capital and physical infrastructure of the main institutions of this supranational IFC.

As part of this effort, the EDB can position itself as a unique institution which can not only catalyse the investment process but also serve as an infrastructure bridge between the capital markets of Russia and Kazakhstan and, potentially, other EurAsEC countries. This is especially important because, according to the survey, the level of mutual Russian and Kazakhstani capital market penetration does not match the actual potential for bilateral cooperation.

Decision-making on capital market integration issues could be greatly accelerated if, following the inception of the Customs Union of Russia, Kazakhstan and Belarus (which seemed unrealistic just a short time ago), the issue of a common currency is once again placed on the political agenda. The adoption of a common currency would spur diverse synergetic effects in the economies of the member countries. In the short – to medium term a broader use of national currencies in mutual trade could have positive effect on the integration of capital markets.

To date, the most serious concerns are centred around the fact that, though the Russian economy faces the challenges of post-crisis rehabilitation, no strategic documents or policies have yet been formulated on the development of the Russian financial market as the backbone of an integrated EurAsEC capital market. This is a dangerous oversight in the context of tough competition between developing markets.

We hope that this publication will contribute to the policy-making and formulation of measures for the development of the capital markets in Russia and Kazakhstan.

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