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The System of Corporate Governance in Kyrgyzstan

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Abstract

The paper is devoted to formation of the modern corporate governance system in Kyrgyz Republic. The main factors that influence this process have been studied, e.g., legal background and practice of privatization; corporate and antimonopoly law; financial markets; stakeholders activities, etc. The authors conclude that there were significant positive changes in the sphere of corporate governance in Kyrgyzstan. First of all it should be marked that in the country that had no previous experience of private property and market, institutions of corporate governance were formed, there was a process of learning of both owners and managers how to govern the company using the available set of laws and regulations. But this process is far from being complete, since the real corporate relations are still very dysfunctional. In the authors' opinion, improvement of corporate governance in the country requires a complex approach: upgrading of legislation must be accompanied by active measures aimed at improving the situation in all spheres that influence the quality of corporate governance. The main task in this sphere is creation of favorable legal and institutional climate which would lead to improvement of common norms of corporate governance and to attraction of external investments.

1. Privatization and evolution of ownership structure

1.1. Privatization program and its realization

1.1.1. Privatization program

One of the main trends of the economic and social reforms conducted in Kyrgyz Republic (KR) is formation of effective market relations in the economy. The main source of the creation of a competitive private sector is privatization of the state property and reduction of the state control over the economy.

In Kyrgyzstan, the processes of de-etatization and privatization started at the end of 1991, virtually immediately after gaining of independence.[1] Now, at the moment of the research, they are 14 years old. Currently the seventh privatization program[2] is being implemented. Every privatization program was developed for the period of several years[3] and had to include the following:

- Tasks and goals of the state policy in the sphere of privatization for the current period.
- Definition of the objects included in the program.
- Methods and means of privatization of the state property.
- Forecast of privatization revenues.
- Forecast of the volume of investments related to privatization.
- A list of the groups of objects exempt from privatization due to the reasons of defense, state security and social development.
- Questions related to the environmental protection and public health, as well as retaining state monopoly in some sectors.
- Procedures of evaluation of the state property being privatized.

The core of the KR privatization legislation is the Civil Code and the Act on Privatization of the State Property in Kyrgyz Republic. Now, the privatization act of March 2, 2002 is in force. The law defines the contents of the program of the state property privatization, participants of privatization, methods of privatization, methods of transforming state-owned enterprises (SOEs) into joint-stock companies (JSCs), procedures of privatization of the state-

[1] The official date of achieving independence is considered to be August 31, 1991.
[2] The press calls it the fifth program.
[3] Initially the programs were developed for the period of 2 years and later for the period of 3 years.

owned enterprises that has been transformed into joint-stock companies, procedures of calculation of the starting price, managing privatization income and its redistribution.

Mechanisms that ensure implementation of norms of the legislation are defined in the following regulations:

- on general conditions and the order of the state' property privatization;
- on the procedures of the state property privatization by management contracts with an option for buy-out, on auctions, tenders, by leasing buy-out, by direct sale;
- on the procedures of case-by-case privatization etc.;

and in methodic recommendations:

- on the evaluation of the property and objects of privatization;
- on the evaluation of land lots owned by the state etc.

The law envisages that in the process of evaluation of the state property not only balance methods of evaluation should be used, but also the methods of market valuation. This greatly broadened the list of by-laws directly or indirectly influencing on the privatization processes. E.g., one should mention:

- the Act on Evaluation;
- "Standards of evaluation to be used by the subjects of evaluation activity";
- "Provisional rules of evaluators' and evaluation organizations' activities";
- regulation "On the Council for Evaluation Activity Development under the State Property Committee," etc.

Realization of each privatization program led to improvement of the legislation, more precise definitions, overcoming of misunderstandings and contradictions. The following Government regulations and President's decrees have contributed to this:

- acts on implementation of the de-etatization and privatization programs and on further steps aimed at development of the de-etatization and privatization processes;
- acts on the effects of the KR economy functioning;
- measures directed against violations and neglects that have been made in the process of privatization.

1.1.2. Stages of privatization[4]

On various stages of privatization priorities were given to various tasks that had to be solved taking into consideration the social and economic situation in the country. In Kyrgyzstan, like in many other countries of the former Soviet Union, there was no experience in the reforming of the state property, thus the process of privatization required continuous

[4] On the basis of the speech of Prime Minister of KR N. Tanaev before the deputies of the Parliament Jogorku Kenesh "On the privatization of the state property in KR," October 2004.

analysis of the passed stages and drawing of adequate conclusions in order to avoid the repetition of the same mistakes. The implementation of every stage was carried out taking into account the conclusions made and experiences that had been accumulated. Every stage had its own positive and negative results.

The first stage of privatization[5] was characterized by implementation of two privatization programs for 1991–1992 and 1992–1993. On this stage the legal background for privatization and attraction of investments was created, as well as the relevant organizational infrastructure. The main accent was made on the "small" privatization of trade objects, catering and consumer services. Small and medium-sized enterprises were sold to their employees. Large enterprises were commercialized and after that up to 75% of their shares were sold to employees at a reduced price. The remaining shares were intended to be sold on the coupon auctions later. Positive effect of the "small" privatization manifested itself in the implementation of market relations in trade and services and in the creation of competitive environment.

At the same time, the process of privatization was burdened by the sins of bureaucracy and subjectivism. Plans of privatization were created by local administrations without taking into account the real situation of enterprises. Then these plans were made more concrete for separate regions and sectors in the form of a certain set of indices. Their achievement was supervised by the administrative organs of lower level, who prepared quarterly reports. Formally, the final decision on the privatization method to be applied to every concrete enterprise was made by the State Property Fund (SPF). It should be said that decisions on the value of each enterprise, way of payment, ownership structure and amount of shares passed to employees were very subjective. In reality, the SPF, or in fact a privatization commission, as a rule, approved the propositions developed by employees and managers.[6] On the first stage of privatization, out of the 10,000 objects belonging to the state that were taken as a basis on January 1, 1991, 44% have been privatized.

The second stage of privatization is characterized by the realization of two privatization programs from: 1994-1995 and 1996-1997. The main tasks of the second stage were carrying out of mass privatization and reorganization of large and medium-sized enterprises in industry, transportation and construction. It is a little bit of a paradox that the government made a special accent on the fact that the quality of privatization is more important than its speed while starting the mass privatization.

[5] Julian Pańków claims, that there were 4 stages before 2004. See J. Pańków, *Progress, rezul'taty i problemy protsessa privatizatsii w Kyrgyzskoy* Respublike, "Issledovaniya i Analiz" ("Studies and Analyses"), no. 223, Warsaw: CASE – Center for Social and Economic Research, 2001.

[6] J. Pańków, *Progress, rezul'taty i problemy protsessa privatizatsii w Kyrgyzskoy Respublike.*

On this stage, the mass (coupon) privatization has been implemented. Every citizen was provided with coupons and the opportunity to get shares of privatized enterprises in exchange for them.[7] The goals of the mass privatization were not achieved fully:

- investment funds haven't started to work effectively;
- there was not enough investment demand for the privatized objects from the population;
- managers of attractive and profitable enterprises had been trying to buy out the coupons from the population before the coupon auctions started to be held.

By the end of the stage, almost a quarter of the KR population became shareholders. For the first time, the problems of privatization of enterprises showing signs of bankruptcy became addressed at this stage. Despite the slowdown in the speed of privatization processes, it can be said that by the end of the period, the formation of the private sector have been basically completed.

On the second stage, out of 10,000 objects of the state property that were taken as a basis on January 1, 1991, 63% have been privatized.

In 1998, the third stage of privatization started. In the framework of this stage, two programs of privatization: 1998-2000 and 2001-2003 were implemented. Currently the privatization program of 2004–2006 is being carried out. The main characteristics of the structural changes of contemporary stage are the reforms in the strategic sectors of economy, privatization of sanatorium and SPA institutions and privatization of the remaining blocks of shares not sold at the previous stages.

At this stage of privatization, the restructuring of strategically important sectors of country's economy has started:

- "Kyrgyzenergo," "Kyrgyzgaz" — fuel and energy;
- "Kyrgyztelecom" — communications;
- "Kyrgyzstan Aba-Joldoru" — transportation, the national carrier.

Privatization of strategic objects is carried out by stages and in accordance with the specially developed programs for each stage that are approved by the Parliament (Jogorku Kenesh). In the framework of such programs, the governments control is provided over some strategically important enterprises that are considered to be in the sphere of national interests of the republic and those that ensure its national safety.

Privatization of such objects is a very sensible process for the whole population of the country. The society is constantly watching the activity of the Government and the Parliament related to the privatization of strategic branches as it is associated with the raise of tariffs.

[7] About 50% of all coupons were exchanged for the stocks of businesses.

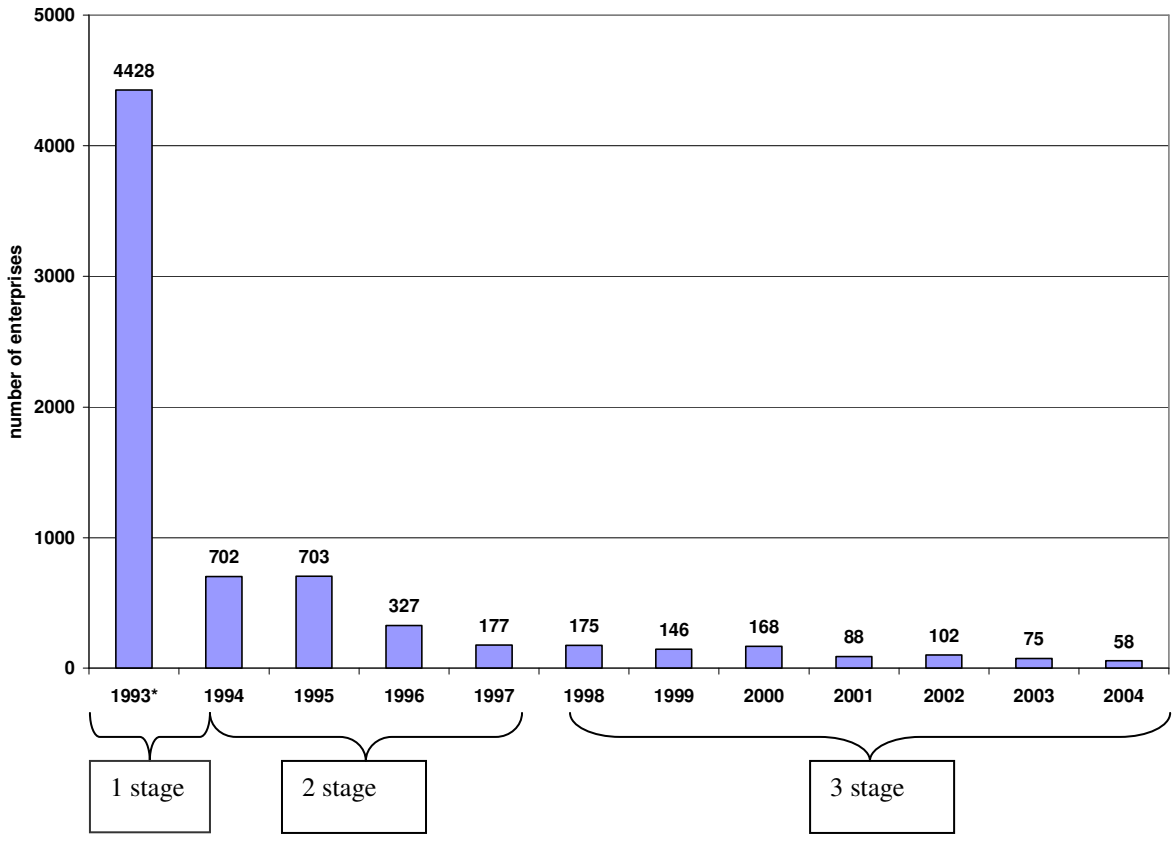
This, in turn, may have serious social consequences in the nearest future that could be also related to decline of the standard of living of the population.[8]

Thus, for the whole period of privatization of the state' property in KR, by the end of 2004 7,149 businesses were transformed.[9] The gross value of the transformed state property amounts to 15,124 million soms.[10] Assets worth 3,353 million soms were passed for free to employees and the population.

1.1.3. Speed and methods of privatization

In 1991-2004, out of 10,000 enterprises designated for privatization 71% were privatized. The diagram 1 shoes the dynamics of privatization measured by the number of privatized enterprises.

Diagram 1
Dynamics of privatization (number of privatized enterprises)



Source: The National Statistic Committee (NSC).

As you can see on the diagram 1, the second and third stages of privatization are characterized by slowing down. Differences in speed at subsequent stages have some ob-

[8] In the Attachment 3 there is an article published by MSN related to this question.
[9] The NSC data.

jective reasons related to the characteristics of enterprises subject to de-etatization, as described above. The slowdown within the periods was due to the flaws of the legislative base. Out of the total number of privatized enterprises, on the first stage 62% of them were privatized, this figure falling to 27% on the second stage and to 11% on the third one.[11]

After the events of March 24, 2005 that led to the changing of power in Kyrgyzstan, the process of privatization was put on hold, as there were and still are found multiple violations of legislation and order of privatization. There are some tendencies for reprivatization or even for nationalization of privatized state property.[12]

Currently, entrepreneurs demand the results of privatization to be acknowledged by the authorities and privatization to be continued in a transparent manner. The Public Prosecutor Office, on the other hand, instituted many proceedings on the facts of illegal privatization of the state property. Several officials of the SPF were accused of illegal action and 13.21% of shares of the Kant cement plant were returned to the state.

According to the SPF experts, passing of the new Act on Privatization of the State Property in KR of March 20, 2002 made possible to make the whole process of privatization fully transparent, to attract more participants for the auctions, to increase competition and thus to obtain higher prices for the privatized property. Such approach provides for prime use of competitive methods of privatization compared to the method of direct sales.

On diagrams 2 and 3 the dynamics of using various methods of privatization on practice is shown.

[10] Except for enterprises in agricultural sector.

[11] During the first six months of 2005 the blocks of shares of six joint-stock companies were sold for 38 million soms.

[12] However, according to the Chief Prosecutor, reprivatization is not foreseen except for the cases of clear violation of law.

Diagram 2
Methods of privatization at different stages of privatization

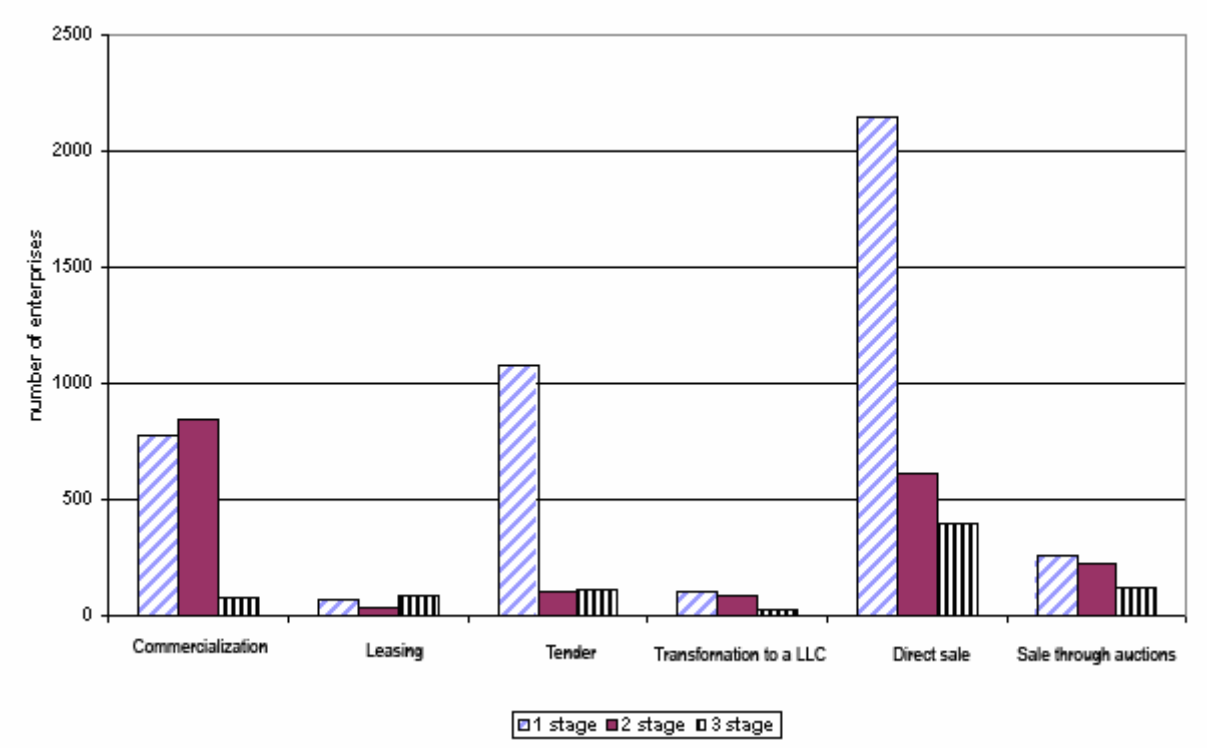
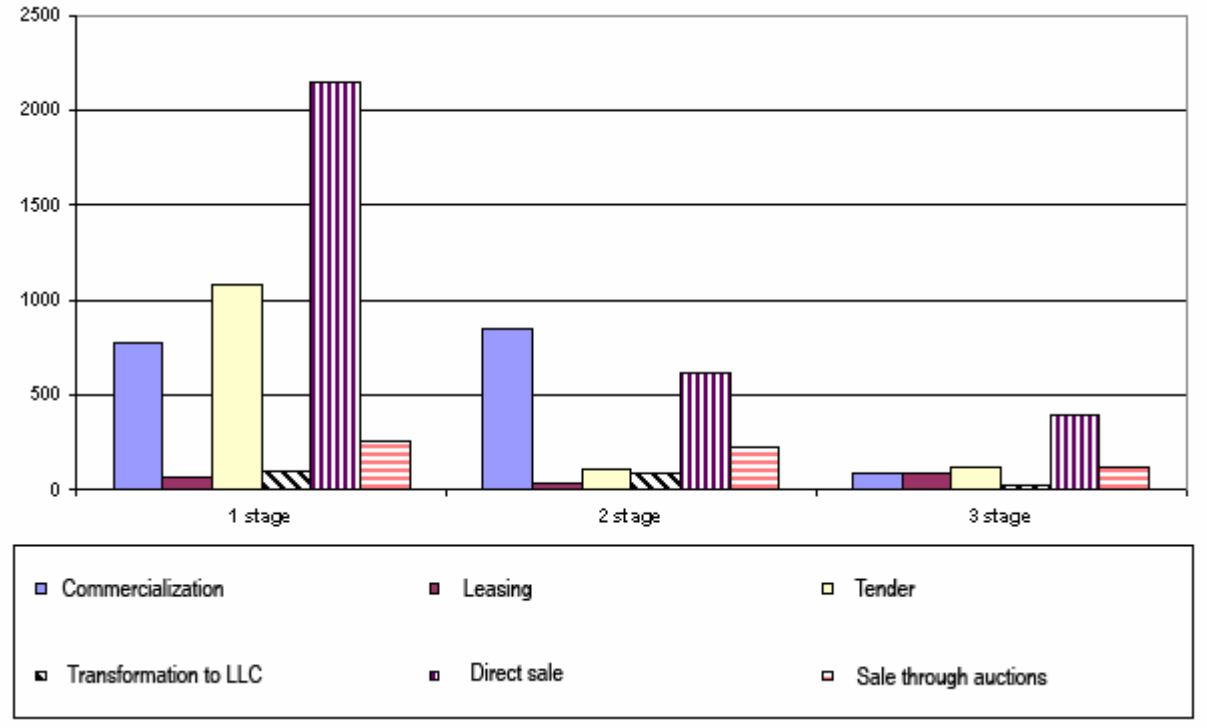


Diagram 3
Stages of privatization and methods used



If we look at the use of methods of privatization during various stages, we can agree with the opinion of the SPP experts mentioned above that was mentioned in the report of Prime Minister in October 2004. But if we look at the data of the NSC from the perspective of methods used, we will see a different picture. Apart from commercialization, direct sale was the leading method through the whole period, although according to the law, it could be used only in special cases after trying to sell the enterprise twice and only to those objects that had not been not sold on open auctions. Although in 2003 a reduction of direct sales and increase of tenders and auctions was observed, this trend didn't prove to be sustainable and in 2004 the situation returned to the previous state.

Speaking about privatization revenues for the state budget, 1,354 million soms were received by the budget which was less than planned. For example, in 2001–2003 only 556 million soms were received instead of the expected 900 million. This is explained by the fact that some objects included in the privatization program failed to attract investors.

All in all, we can say that the efficiency of the privatization policy on all the stages was not very high. The process of privatization was characterized by high level of politicization and low level of public support that created the opportunity for populist calls – sometimes successful – for slowing down privatization, its stoppage or for reviewing its results (the latter even became one of the slogans of the March revolution). There are many influential special interest groups in the country that are not interested in privatization: officials, enterprises getting various rents, misguided population. This leads not only to the slowing down of privatization, but also to the real threat of de-privatization (being in fact a re-nationalization) and/or to redistribution of property justified by the need to overcome violations and to restore justice.

Too many goals were set for privatization, especially on the initial stages, when privatization was regarded as a panacea or a means for solving various social problems. Quite often the goals were too numerous and sometimes mutually contradictive which made their realization harder. Some restrictions on the privatization were excessive – there are still many sectors where privatization is restricted or forbidden due to some political, ideological, group, bureaucratic and other reasons. In particular, it concerns the monopoly sectors that provide public services. The quality of the legal regulations was also very doubtful – privatization programs and legal acts were in some respects too ideological and very frequently contradicted each other and other laws. E.g., in privatization programs there were some terms and instruments absent in the act on privatization. Provisions of the law were often limited and/or changed in by-law acts prepared by the executive power, including SPF.

Speaking about quantitative results of privatization it should be said that compared to the other countries of the former Soviet Union, Kyrgyzstan looks quite positive. The degree of completion of both "large" and "small" privatization is the highest in the region, coming close

to the one of the Central European countries; private sector produces about 75% of the GDP — comparable, for example, with Poland.[13]

But still, privatization is still far from being completed and its results are highly uneven across sectors. There are some sectors that are almost fully privatized: banking, trade, catering, household services, and there are some that are practically untouched like infrastructure, social sector and energy. Currently, everything that was "easy" to privatize politically or technically is already privatized. As a result, the following objects stay under the state control:

- not attractive (both small and controlling blocks of shares);
- not privatized for political, ideological, group etc. reasons;
- not to be privatized because of their public importance, when realization of their functions is more important that their microeconomic effectiveness.

Privatization of enterprises was not followed by the privatization of the land they stand on. Although the privatized objects have the right to use this land and in fact, the circulation of such land is possible, it is very difficult and restricts the opportunities of the enterprises to implement their business strategies.

1.2. Changes in ownership structure after privatization

The initial ownership structure formed right after privatization was characterized by a quite large share of insiders. According to various research insiders possessed, in general, from 42% to 50% of all the shares of privatized industrial enterprises (including 17-20% in the hands of managers).[14] But the main shareholder was the state itself, that averagely owned 44% of shares and in 53% of all the enterprises surveyed the state was the largest owner. Outsider non-state owners were infrequent and foreign investors were also very rare. But even then the concentration of property was quite high: at almost 40% of all the enterprises, the controlling block of shares belonged to one person and at 3/4 of enterprises it belonged to only three persons.

Ownership distribution and redistribution had various speed in different companies which led to the creation of many types of ownership structures. In post-communist countries, their formation usually goes along two axes. The first one is the concentration of property – from dispersed among many owners to concentrated with clearly defined controlling blocks of shares. The second one denotes the level of "outsiderization," i.e., whether the

[13] *Transition Report 2004: Infrastructure*, European Bank for Reconstruction and Development, London 2004.

[14] P. Kozarzewski, J. Kuźma, *Privatiziruyemye i privatizirovannye promyshlennye predpriyatiya Kyrgyzstana. Rezul'tay empiricheskikh issledovaniy*, "Issledovaniya i Analiz" ("Studies and Analyses"), no. 119, Warsaw: CASE – Center for Social and Economic Research, 1997; I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana,* "Issledovaniya i Analiz" ("Studies and Analyses"), no. 221, Warsaw: CASE – Center for Social and Economic Research, 2000.

property remains in the firm (when employees and managers are the main owners) or property rights go outside of the firm.

The four points of these axes describe the four typical ownership structures, originating during privatization in many post-communist countries:

1) Dispersed property in the hands of many employees of the firm;

2) Concentrated property in the hands of management of the company;

3) Dispersed property in the hands of outside shareholders (portfolio ones for example)

4) Concentrated property in the hands of external strategic investors.

Four main groups of owners that have special interests, behavior and aims correspond to these four types of structures.

Unlike many other post-communist countries, in Kyrgyzstan, at least before 2000, there was almost no ownership "leakage" from the firms (see Table 1). Moreover, there was a trend of increasing of the insider shareholdings while the state sold its shares. Initially the concentration went in a quite special way, too, through two independent channels: there was some concentration in the hands of managers who bought shares from non-managerial employees, and at the same time external investors accumulated ownership by purchasing shares from the state. The latest research proved that ownership concentration and emergence of strategic investors or affiliated shareholders possessing the controlling block shares take place first of all in the companies with no state shares.[15]

Table1
Average ownership structure of the surveyed companies (in %)

Owner	Initially	In 2000
1. State	43.6	18.7
3. Domestic banks. funds and other financial institutions	0.5	1.0
4. Other domestic companies	1.7	5.2
5. Former employees of the companies	4.2	7.2
6. Other citizens of KR	4.0	6.9
7. Foreign investors	1.7	4.9
8. Managers	16.6	29.1
9. Other employees	25.5	23.1
10. Other	2.2	3.9

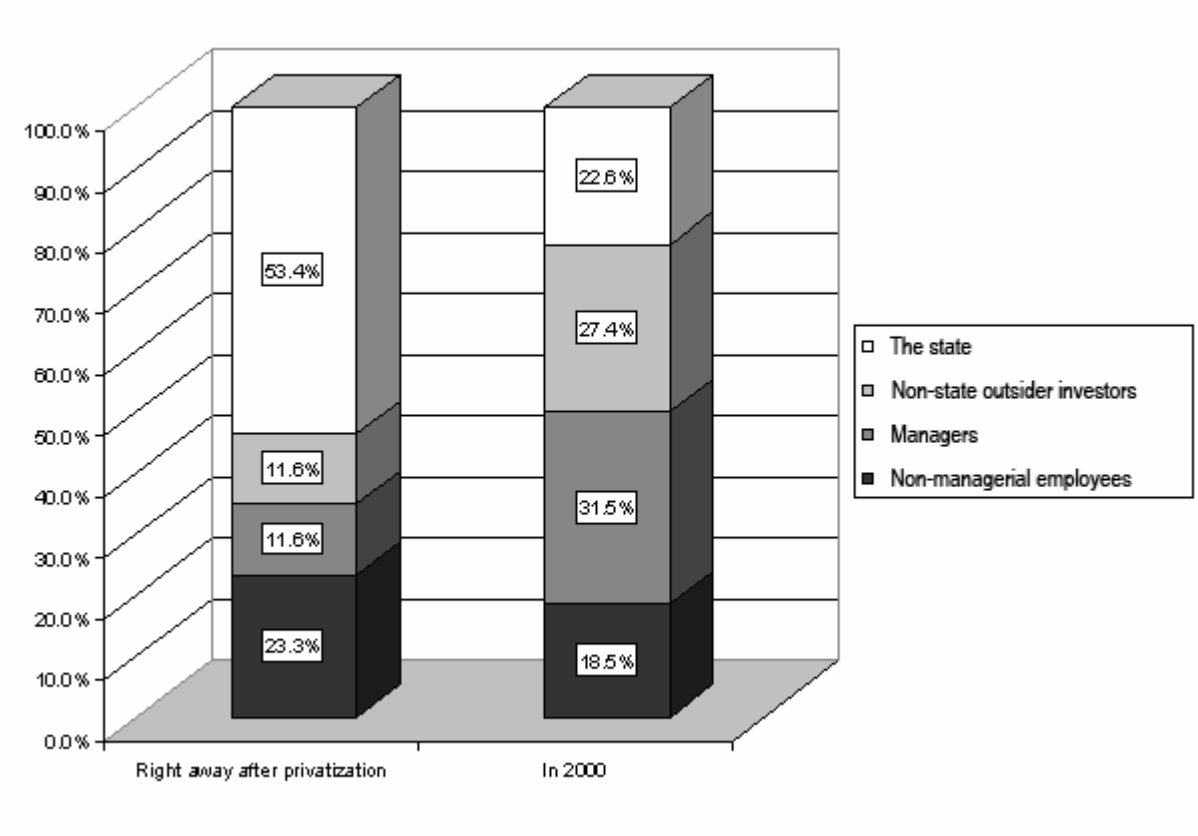
Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana,* "Issledovaniya i Analiz" ("Studies and Analyses"), no. 221, Warsaw: CASE – Center for Social and Economic Research, 2000.

According to the survey held in 2004 in 89 joint-stock companies, in the majority of companies where there was no state shares there was a shareholder owning more than 10%

[15] The cited survey included a representative sample of 151 industrial enterprises from the SPF registry. The main topics of the research were: changes in ownership structure, corporate governance formation, restructuring, and financial and economic situation. See: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana,* "Issledovaniya i Analiz" ("Studies and Analyses"), no. 221, Warsaw: CASE – Center for Social and Economic Research, 2000. This sample is somewhat narrower than the sample used for the current research. The latter includes all the sectors of the economy (the share of industrial enterprises is 93%) as well as enterprises for some reasons not included into the SPF registry. 84 en-

of shares. In every second surveyed company there was a shareholder (or related shareholders) owning more than 30% of shares, and in every second surveyed company without state shares there was a shareholder (or related shareholders) owning the control block of shares. The state share is still very high – in 2/3 of surveyed enterprises it accounts for 50% of shares or more.[16]

Diagram 4
Predominant type of ownership at enterprises (in % to enterprises)



Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

The changes in the ownership structure were caused by many factors. They were the state policy, level of development of market infrastructure, economic situation and investment attractiveness of enterprises, goals of major players on the stock market and in the companies, and many other. There were numerous vectors of the impact of these factors. For example, practical incapacity of some firms made them not attractive for outsider private investors. On the other hand, such firms were very active in looking for such investors and in many cases they were successful. Kyrgyzsan is not an exception: despite the fact that the degree and the speed of de-etatization (transfer of shares from the state to private hands)

terprises were idenitified as present in both samples although the real number may be bigger because of problems with identification caused by possible changes of enterprises' names and registration numbers.

was in general higher on profitable enterprises, unprofitable firms very quickly went under the control of external non-state investors (see Table 2)

In general, the survey showed the reluctance of insiders to release the control over the firms. For the most managers (and other employees) this control was, generally, more important that the search for investments. The passing of part of the property to "strangers" was a forced measure to avoid the collapse of the firm. But usually not the strategic investors used this situation but the creditors organization to which this firm was indebted.

Table 2
The largest shareholder and gross profitability in 1994 (in % of firms with given profitability)

Profitability in gross	State		External investors		Management		Common workers	
	initially	in 2000	initially	in 2000	initially	in 2000	initially	in 2000
Negative	75.0	45.0	10.0	40.0	5.0	10.0	10.0	5.0
Positive	48.5	17.8	12.9	26.7	14.9	36.6	23.8	18.8

Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

As a result, in the privatized sector of Kyrgyzstan one of the most widespread are the "insider" forms of ownership structure (types 1 and 2) and the third form is almost nowhere to be found. This is related to the narrow and underdeveloped stock market. The state share is still very large. According to the above mentioned newest surveys, it still owns a controlling block of shares in about 1/3 of all enterprises.

The share of external concentrated owners, especially foreign (apart from the banking sector) is still not very large and not only because of insiders' resistance that looses its actuality at the present stage of privatization (privatization of large objects, mainly in infrastructure, where insiders are not able to act as a part of a deal), but mainly because of the lack of domestic capital, low attractiveness of the objects and very unfavorable investment climate (high corruption, faulty legislation and restrictions for foreign capital in privatization of some objects and land lots). Low volume and low quality of direct foreign investments (FDI) is the Achilles' heel of the Kyrgyz economy. The country holds one of the last places in the CIS according to the level of the FDI per capita. Mainly the regional capital and the capital of dubious origin ("fled" capital that is now returning through off-shore territories and men of straw) enter the country. Apart from insufficient infusions into the economy, such situation blocks the transfer of knowledge, technology, experience, access to markets and so on. All that could be provided by foreign investors of "the first-class" (with good track record, out of developed countries).

[16] *Issledovaniye praktiki korporativnogo upravleniya v aktsionernykh obschestvakh Kyrgyzskoy* Respubliki, Bishkek: Center for Corporate Development under the Government of KR, 2004.

2. Development of financial markets

2.1. Banking sector

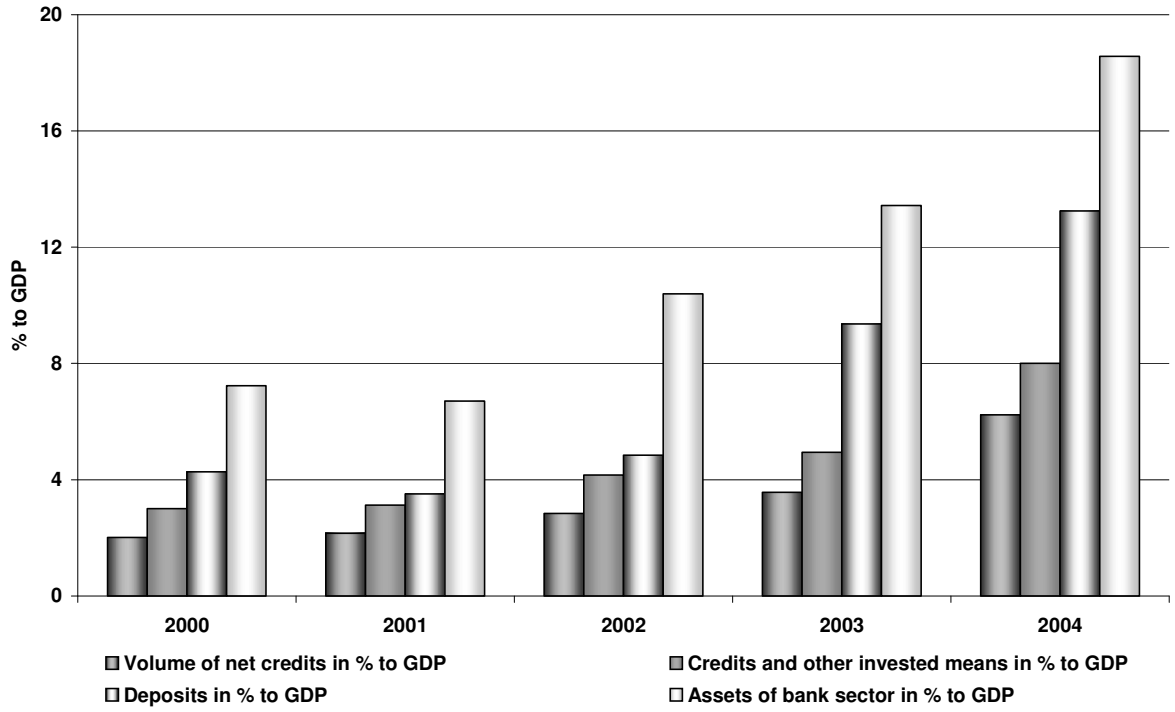
The banking system of the country consists of the National Bank of KR (NBKR), commercial banks and microfinance institutions (MFI). The activity of commercial banks is regulated by the Act on Banks and Banking in KR adopted in 1997. According to the act, a bank is created in the form of joint-stock company and acts on the basis of the license issued by the NBKR. The main regulation of the microfinance institutions activities is the Act on Microfinance Institutions in KR adopted in 2002.

2.1.1. Commercial banks

Banking sector of KR is represented by 19 commercial banks. 14 out of them have foreign capital participation out of which in 9 banks foreign capital share is more than 50%. On average, the share of foreign investors in the authorized capital of Kyrgyz banks by the end of 2004 was 46.5%. Foreign capital is represented by banks of Russia, Kazakstan, Pakistan, Korea and Turkey. There is also a bank founded by several international financial institutions (International Financial Corporation, Aga Khan Fund, European Bank for Reconstruction and Development and the Government of KR).

Capitalization of commercial banks in 2004 equaled to $55 million. The dynamics of the financial mediation indices given in the diagram 5 shows that the presence of the banking sector in the economy is gradually increasing. But its role is still can't be compared not only to developed countries, but also to closest neighbors such as Russia and Kazakstan. In the period under review, the share of the banks' assets in GDP increased 2.5 times and now amounts to 18.6%. The volume of net credits having also increased almost threefold in comparison to 2000 in relation to the GDP, amounts to modest 6.2% in 2004.

Diagram 5
Dynamics of assets, credits and deposits in 2000-2004

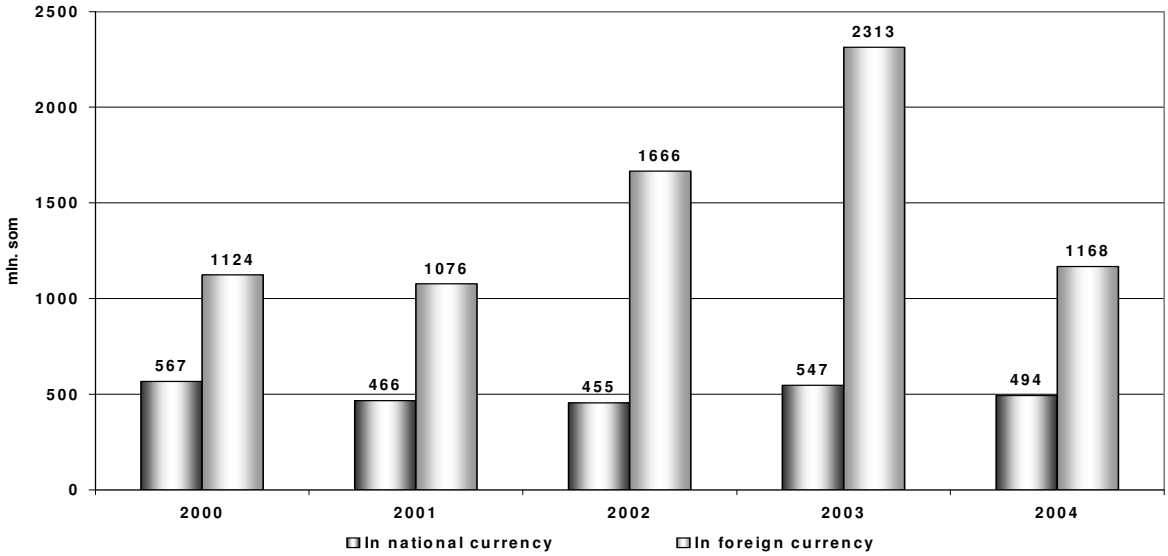


However it should be said that the stable microeconomic situation, growth of economy, decrease of the inflation rate and stabilization of national currency during the last years provided for dynamic development of deposit and credit market (Diagram 6).

The main category that caused the broadening of the deposit base of commercial banks were à vista deposits of legal persons. Time deposits of legal persons and deposits of population were also increasing, but slower. But the increased inflow of new deposits was accompanied by decreasing interest rates.

The increase in the assets of the banking system and the inflow of foreign capital to the banking system of the republic provided for accelerated growth of the volume of credits given to the real sector. Growth rates of credits in foreign currency were higher than that in soms. The growth of the credit portfolio was accompanied by improving of its quality. The proportions of overdue debts in the joint credit portfolio of banks reduced. One more positive tendency of 2004 is the increasing of the long term credits' in the structure of credit portfolio from 21.5% to 27.5%. Nevertheless, the average term of credit repayment is still quite low and equals to 14.8 months.

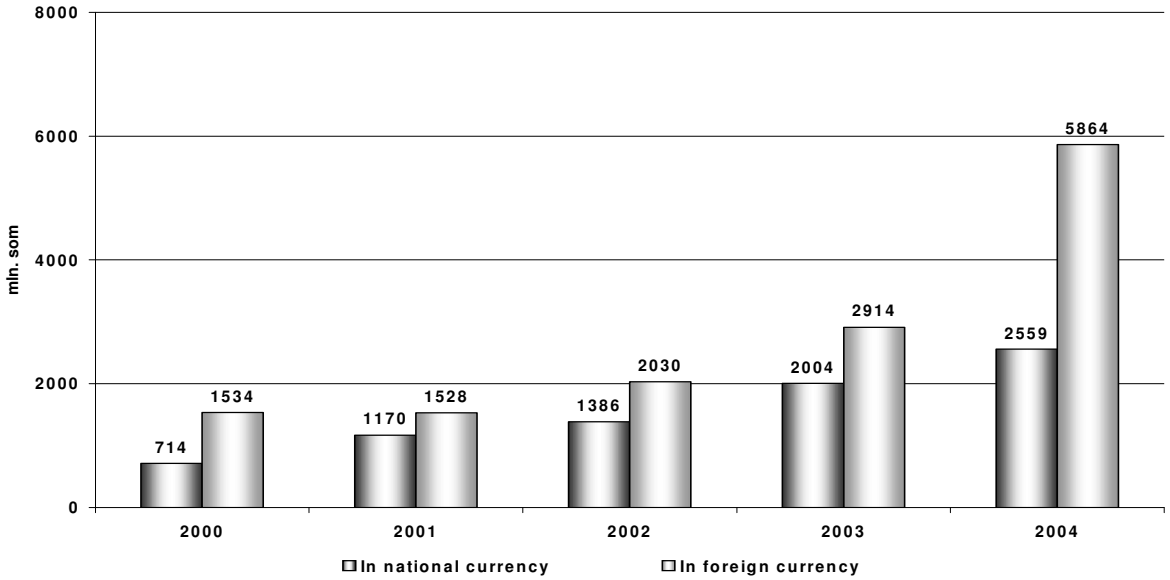
Diagram 6
Volume of deposits in commercial banks (by the end of period)



Some reduction in the cost of resource base of crediting allowed the banks to reduce the credit interest rates. Average annual credit interest rates in national currency totaled to 24% and in foreign currency – 18.9%. The reduction of the interest rates for new credits has been observed in practically all categories and branches and the volatility of rates decreased considerably. Together with the reduction of nominal interest rates, a reduction in the real cost of credits was observed. It achieved its minimal level since 2000 and was as low as 19.8%.

Concentration index of credit portfolio of the banks has decreased and by the end of 2004 equaled to 10.7%. It means that the crediting market has been divided between the banks.

Diagram 7
Volume of credits in commercial banks (by the end of period)

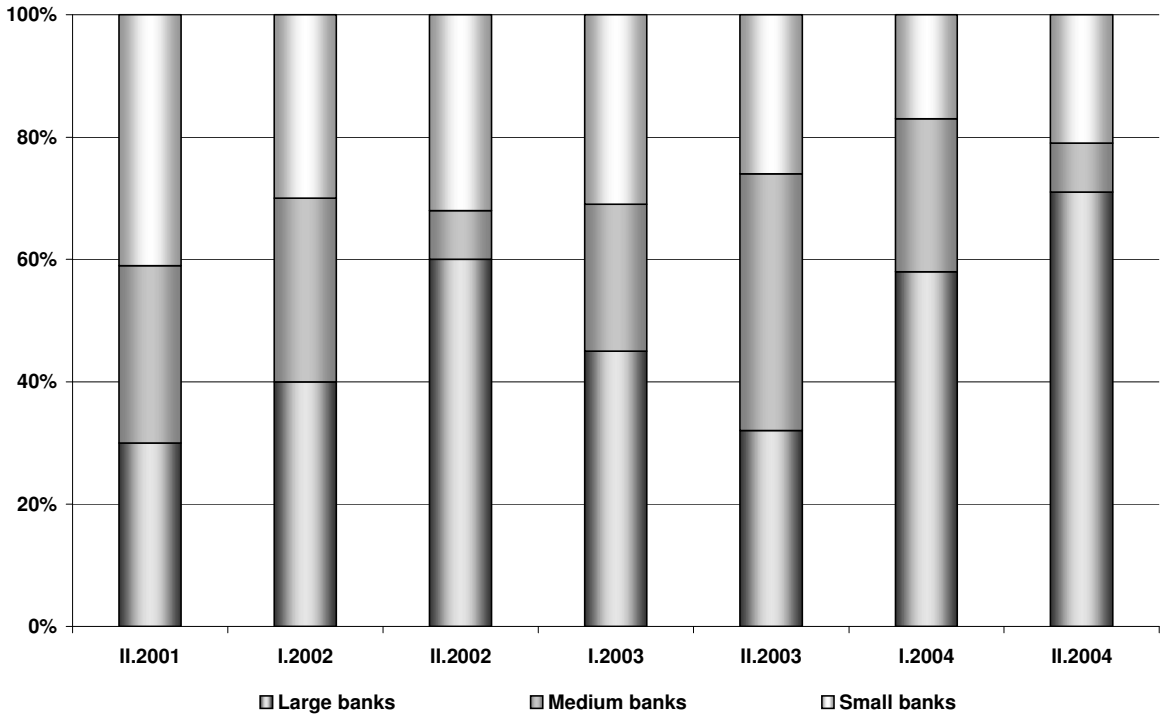


The analysis of the banking system structure regarding the segments of large, medium-sized and small banks, shows that the structure of the banking sector is not stable.[17] Currently the average amount of assets of the four largest Kyrgyz banks is $22 million ($14 million – $53 million). The increasing share of the large banks in 2004 can be explained by the appearance of several Kazakstan banks on the Kyrgyzstan financial market. But the analysis of the efficient use of assets and capital shows that small banks are the most effective. And the largest bank (i.e. the bank with the largest share on the market) is the least effective, as its leading position is determined only by the increase in cash assets.[18]

[17] Banks are classified according to the average bank's share in total assets, credits and deposits: "large" – more than 10%, "medium-sized" – 5-10% and "small" – less than 5%.

[18] *Tendentsii razvitiya bankovskoy sistemy KR*, NBKR: Bishkek, 2004.

Diagram 8
Dynamics of banking sector structure in Kyrgyzstan, 2001-2004



Although there are some positive tendencies in the development of the banking sector, it still experiences serious difficulties. The amount of deposits is not enough for stable development of the real sector that is in high need of cheap credit resources. Population still doesn't trust the banking sector. This is due to the limited resources of most commercial banks and disadvantageous conditions on which credits are given:

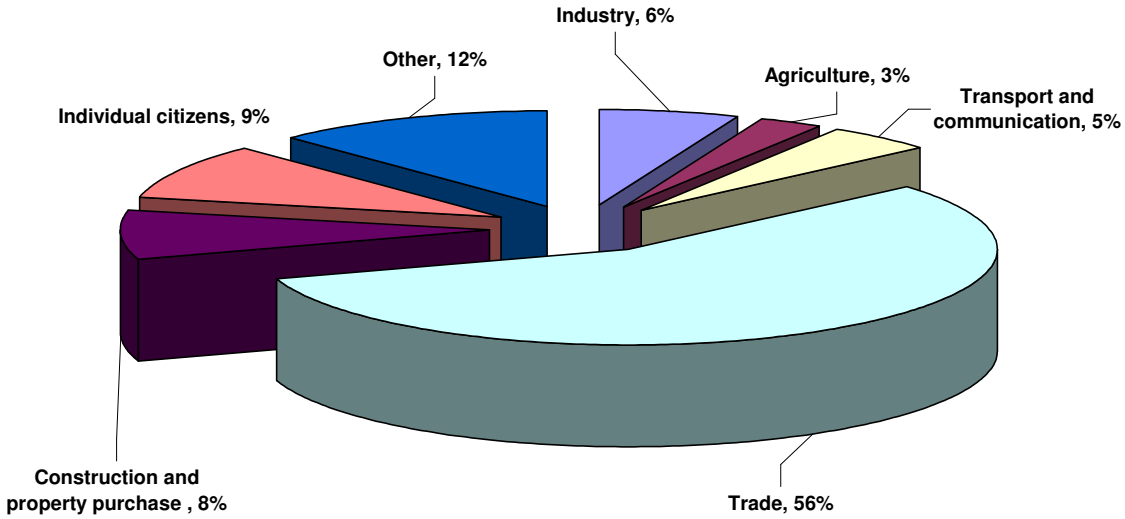
- interest rates, having the tendency to decrease, are still very high. Besides, there is a tendency give preferential credits to affiliated companies or simply "friends." The Table 3 shows the conditions of crediting in the largest and most stable banks of KR;
- credit attractiveness for potential clients is substantially limited by very high collaterals requirements which reach 150-200% of the amount of credit;
- a lot of banks have no opportunity to prolong credits that is partially related to the terms of deposits that usually are not longer than one year. Such credits are not attractive for companies as they are too short for their business cycle, especially in agriculture and industry. Diagram 9 is a clear illustration of the situation. More than a half of banking credits is used in trade. The share of credits for industry and construction is only 15% of the banking sector credit portfolio.

Table 3
Credit conditions in the largest banks of KR, 2004

Bank's name	Credit sum, $	Annual interest rates, %		Collateral, % of credit's sum	Term, years
		Nat. currency	For. currency		
Kyrgyz Investment and Credit Bank	50 thousand. – 1 million	14-16	14-16	Flexible	Up to 7
Energobank	5 thd. – 1 mln.	15	15	150-170	Up to 7
Bank Kyrgyzstan	200–50 thd.	–	20-28	150-200	Up to 3
Ineximbank	100–400 thd.	30-35	11-28	120-150	Up to 7
Promstroybank	200–500 thd.	10-50	10-35	120-150	Up to 1 ½
Bank Bakai	500–100 thd.	30	26	300	Up to ½
Kazkommercbank Kyrgyzstan	2–450 thd.	20-35	18-28	Flexible	Up to 3
Demir Bank	1–400 thd.	–	10-25	140	Up to 1

Source: *How do companies in Eurasia finance their trade/investment deals*, BISNIS 2004.

Diagram 9
Structure of credit portfolio of commercial banks of Kyrgyz Republic, 2004



2.1.2. Microfinance organizations

The main task of the microfinance organizations (MFO) is the support and development of the social mobilization of the population. It is aimed at strengthening of capabilities and broadening opportunities for poor people in overcoming poverty, in developing their profit-making activity, and increasing their independence by providing access to microfinance resources. MFOs are not a part of the banking system: they give small loans to target group of citizens and use their own principles of crediting. MFOs can operate using their own assets

or with the help of loans from local and international financial institutions. The latter is very important for the Kyrgyz microcrediting market. The largest donors of MFOs are: the World Bank, the USAID, Asian Development Bank, the International Financial Corporation, the European Bank for Reconstruction and Development, Tacis, German Development Bank, and the Government of KR (which uses for this purpose 3% of privatization revenues and the employment fund of the Social Fund).

The donors that implement microfinance programs in KR are:

- international organizations: Mercy Corps International, FINCA, Financial Fund "Bai Tushum;"
- local non-governmental organizations: Citizen' Fund of Microcrediting, Financial Fund "Kyrgyzayiltrust" and others;
- State organizations: Kyrgyz Agricultural Financial Academy, Financial Company for Support and Development of Credit Unions, State Fund for Support of Small and Medium-sized Business under the Government of KR, State Department of Employment in the Ministry of Labor and Social Protection;
- local commercial banks: Ineximbank, Kyrgyzstan Bank, Demir, Kazcommercbank–Kyrgyzstan, Energobank;

Microcredits are given to a group of people or to a person. As a rule, when financing a group, no material collateral is required. A "social collateral" is used instead – joint amenability of the group of credit takers or guarantees issued by a third party. Some creditors use collateral principle. A principle of orientation on the credit taker himself is often used, on his/her desire to work and be persistent in achieving the goals set.

By the end of 2004, there were 78 MFOs registered. The share of microcredits in the whole credit volume is 15%. Microcrediting activity is mainly directed towards inhabitants of large cities. This is proved by the fact that the amount of assets directed for agricultural credits (to the main activity in rural areas) is only 16.1% of the total MFOs credit portfolio. The main object of crediting by MFO is the trade sector. The volume of credits for this sector in 2004 was 75% of the whole credit portfolio of MFOs.[19]

The average size of a microcredit in 2004 was around $500, achieving its maximum value in real estate sphere — $5000. As a rule, microcredits are given for one year, and only 1/5 of all MFOs give them for up to three years. Interest rates of microcredits are, in general, 5% - 6%, lower than for other credits. 67% of MFOs prefer collateral in the form of real estate, others work on the basis of non-collateral system. Recurrence of credits is averagely 96%.[20]

[19] *Tendentsii razvitiya bankovskoy sistemy KR*.
[20] *Sostoyanie mikrofinansovogo sektora v Kyrgyzskoy Respublike,* Bishkek: "Expert" Agency, 2004.

2.2. Securities market

Issue and circulation of securities and the questions of state regulation of securities market in KR are regulated by the 1998 Act on the Securities Market. The supreme organ of state administration that is in charge for the integral state policy related to securities market is the State Commission for Securities Market under the Government of KR (SCSM). It performs the following functions:

- develops the main directions of development of securities market and coordinates all the governmental activities on this field;
- develops relevant legal acts and supervises their execution;
- approves the issue standards for securities;
- holds the unified registry of securities;
- develops the unified standards and rules of professional activity with securities, including reporting by issuers and professional participants, preparation of methods of evaluation of corporate securities, of keeping the shareholders registry, conducting of clearance and depositary activity; securities keeping custody;
- establishes the compulsory requirements and other conditions for issue and circulation of securities;
- issues licenses for professional participants of the securities market;
- registers issues of securities;
- supervises the activities of professional participants of the securities market.
- provides the common informational space on securities and financial markets, creates an open-accessed base with information on issuers, professional participants of the securities market and on its functioning;
- approves qualified requirements for professional participants of the securities market and contributes to their professional growth.

During the first 8 months of 2005, 35 objects were audited by State Commission for Securities Market. The results show that most violations of securities legislation in KR is related to initial distribution of shares during the privatization of firms, general meetings of shareholders and non-payments or wrong calculation of dividends.

On the stock market of KR three licensed securities traders operate: Kyrgyz Stock Exchange (KSE), Stock Exchange Trade System, Central Asian Stock Exchange. According to the results of 2004, 86% of all securities trade in value was done at the KSE.

The KSE was founded in 1994. The first auctions and official opening took place in May 1995, when the process of privatization was in full swing. On the initial stage of its existence, the KSE operated as a membership-based non-commercial organization with 16 members.

In 2000 it was commercialized. The Istanbul Stock Exchange became one of the core investors of the KSE. In 2001 the Kazakstan Stock Exchange also became a shareholder which allowed the KSE to increase significantly its programming and technical potential. Currently the KSE is a “closed” joint-stock company with 17 shareholders. Membership was abolished by the general meeting of shareholders. The relations with participants of biddings are contract-based.

In accordance with the Act on the Securities Market, the KSE develops and approves its own rules of listing and delisting of securities. To get the permission to be included on the quoting list, an issuer must submit a standard set of documents to the listing department of the KSE. If the decision is positive, the contract is signed between the issuer and the KSE.

The securities of the issuer can be given one of the three categories of the quoting list – A, B or C. The main difference between them relates to capital requirements and to the date of the foundation of the issuer organization. So in order to get the A category, own capital must be no less than $5 million (in soms according to the exchange rate of the NBKR) and the organization must exist (to pass the initial state registration as a legal person) at least 5 years. For B category, the capital must be no less than $1 million and the firm must exist for more than 3 years. And for C category, the capital must be at least $250 thousand the company must exist for at least 1 year. Other requirements for including the securities into the list are the same for all the categories.

The stock exchange has a right to exclude the securities from its quoting list on the following grounds:

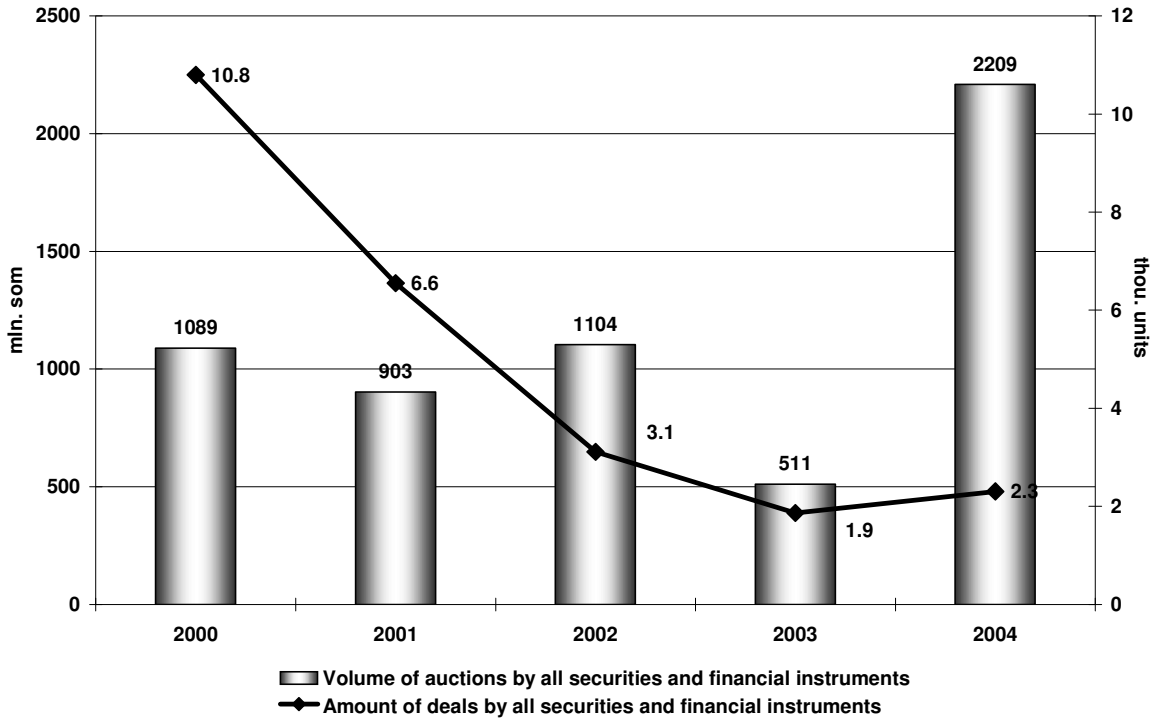
- the indices of issuer activity do not conform to the requirements for entering the quoting list;
- upon request of the issuer;
- liquidation of the issuer or if the issuer is declared bankrupt;
- cancellation of state registration of securities issue, included into the quoting list;
- expiration of securities circulation;
- failure of the issuer to meet the obligations of the agreement.

Some issuers can be excluded from the list temporarily by the decision of the KSE. Having solved the problems that led to the exclusion, the issuer is restored on the list.

During the ten year of operation, 34,145 transactions were made on the territory of the KSE on the sum of 6.3 billion soms or $138 million. During the last five years, in spite of the decrease in the amount of transactions (see Diagram 10), their value has increased two times and in 2004 equaled to 2.2 billion soms or $51 million. This shows that the turnover on the stock market of the republic is not large and big transactions can influence it greatly. Now only 8 companies are the regular players of the stock market. Since 2003, only one fifth of

the total trade volume of securities is made by the companies that passed the listing procedure.

Diagram 10
Dynamics of the trade volume at the Kyrgyz Stock Exchange, 2000-2004



From January till August, 2005, 2,263 thousand transactions on the total sum of 787.6 million soms were made. It is 26% less than in the same period of the previous year. As usual, 80% of all the trade was held at the KSE.

There was an attempt to revive the almost dead stock market with the help of administrative methods. According to the current legislation, all securities transactions must be registered with the KSE, no matter where they were made. Besides, the privatization program provides for selling all the remaining state shares through the KSE. Such policy gives KSE the functions not designated for it and lowers the quality of the organized securities market. Currently and in the nearest future the role of KSE is objectively restricted by the lack of stock market players: population has no money and institutional investors are almost absent. As a result, the KSE does not implement any of the most important functions of the stock market, i.e. market evaluation of enterprises and provision of capital.

The results of the survey conducted in 2000 show that the weakness of the organized stock market comes from the reluctance of the firms to participate in it as well. Many managers were very skeptical about listing of their stocks at the KSE – only 38% of all respondents were positive about it. In the case of listed companies (their number was not very high in the

sample – only 13%), more than a half of the managers positively evaluated this fact and only 20% negatively. The firms controlled by external non-state owners generally were positive about the stock exchange and the firms with dispersed employee ownership were negative.[21] Probably the main reason of negative attitude towards the stock exchange and to the participation in it was the fear of loosing control over the firm.

3. Corporate governance system

3.1. Legal background for the system of corporate governance

3.1.1. Model of corporate governance

The so-called Continental model of corporate governance is adopted in Kyrgyzstan. Unlike in the Anglo-Saxon model that consists of two governing bodies – the general meeting of shareholders (that fulfills ownership functions) and the board of directors (that fulfils the functions of management and supervision), in the Continental model functions of control and supervision functions are strengthened by their separation. This model consists of three bodies – general meeting of shareholders, managing body (executive board in charge of day-to-day management) and supervising body (supervisory board which in KR is somewhat misleadingly called the board of directors). A person cannot sit on the both boards at the same time. In the majority of post-communist countries this very model is adopted as in the transition economies, where the so-called mechanisms of external control (in the form of financial, commodities and other markets) are still not efficient enough, the so-called internal control performed by owners becomes crucially important. In Poland, for example, the three-tier system of corporate governance applies not only to all joint-stock companies, but also to significant part of limited liability companies.

On 24 November 1994, the Regulation “On Corporate Governance” was issued by the KR government. The order of introducing corporate governance in companies, the functions of board of directors, executive boards and managers, relations with state bodies and owners are defined there. The further development of legislative basis in the sphere of corporate governance was strengthened in the first part of the Civil Code passed in May 8 1996 and in the Company Law passed in November 15, 1996.

The Civil Code and the Company Law were both too general, and in the country having no experience in corporate governance in the conditions of private property and market, the

[21] I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh pred-*

lack of instructive elements of legal acts was evident. The laws were also contradictory and frequently not precise. On July 26, 1997 the KR government issued the Manual for Corporate Governance in KR. It was an accompanying document for the Model Charter of a Joint-stock Company.

The concept of corporate governance, principles put at its foundations, schemes of corporate governance used in other countries were written in details. This document although being very up to date, confused many people by using unfamiliar terms, not foreseen by legislation and its style pretty much reminded the popular article in the economic journal. Standard Charter of a joint-stock company also can't be unambiguously evaluated. On the one hand it made the vague and incomplete definitions of laws more understandable, but on the other its concretization very often restricted the possibilities given to shareholders the by the law as officials required the company charter to be in accordance with the Model Charter (i.e., de facto the document of a lower rank had more power than the higher one).

On 28 January 2003, after three readings and almost two years of discussion in the Parliament (Jogorku Kenesh), the Act on Joint-stock Companies was adopted. All other norms related to JSCs mentioned above lost their power, apart from the Civil Code.

The law confirmed the Continental character of the corporate governance model. The bodies of a joint-stock company are:

- ***General meeting of shareholders –*** the supreme body in a company. The questions related to charters, reorganization and liquidation of the company, decision making on large transactions, elections of a general director, elections of members of the executive body, board of directors and members of auditing commission, decisions on the amount and order of dividends' payments, remuneration and other vital aspects of the company are in the jurisdiction of this body.
- ***Board of directors –*** body that governs the company in the period between the general meetings of shareholders. Its exclusive competence is the decisions on the strategic goals of the company, formation of its policy and supervision of their implementation by the executive body.
- ***Executive body –*** the body that manages the day-to-day activity of the company.[22] This body implements the decisions of the general meeting of shareholders and the board of directors, prepares the annual report and budget, and makes reports on financial and economic activity of the company. It also reports on achievement of the company's policy and targets.
- ***Auditing commission*** is the body that controls financial and economic activity of the company.

priyatiy Kyrgyzstana.

There is a restriction on the combination of functions in the bodies. Members of the executive body and the auditing commission can't be members of the board of directors at the same time. Deputies of Jogorku Kenesh (full-time, i.e., not working elsewhere), members of the government and other state officials can't be members of a board of directors, an executive body or an auditing commission.

The adoption of the Act on Joint-stock Companies meant the significant improvement in the legal base of corporate governance. First of all, we should mark out its high detailed elaboration – the law, finally, became (at least theoretically) not only a regulator but also a kind of a manual for companies. However, its actual users point out that the law is badly prepared from the legal point of view. Apart from lack of sense and contradictions of some norms of the law, they point out the weak knowledge of legal language by the authors of the law.

The level of property rights protection on a company level is still not optimal. First of all, the legislation was devised under powerful impression of Anglo–Saxon model with its characteristic dispersed ownership and related to it protection of minority shareholders. It gives preferences to minority owners and insiders and restricts the opportunities of large external shareholders to purchase shares. But the reality of the Kyrgyz economy causes that minor owners are and in foreseeable future will be a small category of investors. Moreover, experience of other countries in the region shows that minority shareholders can be used by some financial–industrial interest groups for a hostile take-over of a company. Insiders, in turn, don't have sufficient potential to improve functioning of their company. Secondly, there is no legal requirement to increase the authorized capital after a new issue of shares. This peculiarity comes from the idea, that additional expenses on registration of increased authorized capital are too high for many companies and therefore they would refrain from additional capitalization. But such a provision distorts the information on the potential of the company (and may impede attraction of further investments) and limits their responsibility to creditors. And finally, the role and functions of the board of directors is not clearly defined in the law, thus weakening the protection of interests of the main categories of shareholders and the company itself.

Among other serious faults that were discovered in the course of implementation of this act and hinder the effective implementation of corporate governance, the most common problems concern investors, quorum on the annual general meetings, board of directors elections, large transactions, protection of the shareholders rights to participate in meetings and their voting rights, as well as competencies and methods of creation of the bodies of a joint-stock company.

[22] It can be individual or collective (directorate, managing board).

3.1.2. Disclosure

A number of internal problems of corporate governance is related to the fact that owners do not directly participate in the process of managing the company and pass their rights to managers. Thus the problem with informing arises. Owners have much less information on financial situation and technical problems and day-to-day functioning of the company, while managers who perform everyday management have sufficient knowledge and skills to understand and effectively use such information.[23]

The provision of such information to the owners in sufficient amount and up to date is therefore a very important legal task.

The process and order of information disclosure is regulated by the Act on Joint-stock Companies and the Regulation "On Disclosure Requirements on the Securities Market".[24]

The Act defines a list of documents to which the management of a company must provide access for shareholders. They are: constitutive documentation, annual, quarter and other reports, issue prospectus, general meetings, board of directors and auditing committee meetings' minutes, lists of affiliated persons with information on amount and category of the shares they possess, and other documents envisaged by the law of KR, company's charter, decisions of the general meeting of shareholders and the board of directors.

In the Regulation "On Disclosure Requirements on the Securities Market" the order and scope of information disclosure is defined for the following players of the securities market:

- issuers;
- professional participants of the securities market;
- self–regulating organizations;
- owners of securities;

The regulation also includes the order of report submission by the above-mentioned persons and organizations to the state body in charge of the stock market regulation.

In order to provide additional protection of property rights a new unit within the SCSM structure was created in 2001: the State Fund for Storage and Processing of the Securities Market Information. The main task of the fund is the increasing of transparency of the securities market mainly through disclosure.

Currently the only evidence of its activity is disclosure of information on a purchase of 5% of shares in JSCs. This information is presented and is regularly updated on the website of the SCSM.

[23] *Manual on corporate governance.*
[24] Approved by the State Commission for Securities Market on December 16, 2002.

According to professional participants of the securities market, not a single company wants to expose its secrets to its shareholders. And the control over corporate relations is not performed by any specific structure.

3.1.3. Antimonopoly regulation

The Act on Joint-stock Companies defines some mechanisms for merging, acquisitions, splitting, spin-off and reorganization of joint-stock companies. The questions of reorganization are solved by the majority of votes on the general meeting of shareholders. Quorum is achieved if 60% of shareholders, including the holders of privileged shares are present. As a rule, the decision is made according to the interests of major shareholders. The state has no means of influence on the decision-making in favor of minor shareholders. Such means of influence become active only when there is a violation of antimonopoly legislation.

The National Committee for Protection and Development of Competition under the President of KR (NCPDC) is in charge of antimonopoly regulation. This structure functions according to the Act on Restrictions on Monopoly Activity, Development and Protection of Competition adopted in 1994 and amended in 2003. According to the law, no company can occupy a dominant position on the market as it will hinder the development of competitive environment. The position is considered dominant when the company' product occupies more than 35% of the product' market.[25]

The NCPDC supervises merging or acquisition of joint-stock companies in order not to allow for forming a monopolist. That is why the reorganization procedures in joint-stock companies that lead to expansion of their activities require a permission of the NCPDC.

If a joint-stock company that has a dominant position exercise monopolistic activity or its actions substantially limit competition, the NCPDC has the right to make the following decision:

- to perform a mandatory split;
- to exact undue profits;
- to charge for a damage, including lost profits of the companies from the given market segment;
- to impose a fine.

Nevertheless, in the conditions of underdeveloped monitoring systems and lack of experience, it is hard to prove a dominant position of a company. In practice, there were no cases of splitting a monopolist.

[25] In some cases limits for a market share is set by the antimonopoly body.

3.1.4. Bankruptcy

Another very important from the corporate governance point of view is the Act on Bankruptcy adopted in 1997 and changed several times since then. According to the law, a procedure of special administration (liquidation or reorganization) is applied to the joint-stock company that is declared bankrupt. Bankruptcy procedure can be initiated a debtor. The minimal required debt sum is 5000 minimal salaries[26].

3.2. Mechanisms of corporate governance

3.2.1. Large shareholders

As it was mentioned above, the legislation of KR gives preference to the protection of small investors and insiders, which is a doubtful strategy in the conditions requiring the attraction of large external owners. The following methods are used to protect insiders and minority shareholders:

- in case of public offer of shares and securities by a company, the existing shareholders have a pre-emptive right for the new issue proportionally for the amount of shares belonging to them. Taking into account the initially insider-dominated ownership structure of privatized companies, this leads to the large concentration of shares in the hands of one shareholder or a group of shareholders without "outsiderization" of ownership structure;
- the law requires a person who wants to acquire more than 50% of a company's shares (together with the already possessed shares) must send a written request for the purchasing of the shares to all the other shareholders (mandatory bid);
- the specific procedure of re-evaluation of shares of the initial issue after an additional issue that applies only to privatized companies.

Any physical or legal person that has the direct or indirect influence on decision-making in a joint-stock company is regarded as an affiliated person. According to the law, managers and shareholders having five or more percent of voting shares of the company are defined as affiliated. The holders of more than 5% of shares have to inform the company and the SCSM about the amount and category of the shares that they possess.

The above-mentioned peculiarity of KR is a great role (at least formal) of the State as an owner. By the end of 2004, the State had shares in 148 joint-stock and LLC companies in various branches of the economy. The total value of the state share in them is 10,312 million

[26] Minimal salary in KR is 100 soms.

soms or 68% of all the estimated value of state-owned enterprises included in privatization process. The State has shares in 132 joint-stock companies. In 85 joint-stock companies the State has the controlling block of shares, so the State is interested in taking part in managing these companies.

In such a case, the State has to solve several tasks: on the one hand, this is asset management and on the other hand this is the task to provide for the state representation in the bodies of a company. The following regulations were developed to solve these issues:

- "On the Order and Conditions of Management Buy-ins in Selected joint-stock Companies Owned by the State;"
- "On the State Representatives On the Boards of Directors of Joint-stock Companies Owned by the State."

The regulation "On the Provision of the State Interests in the Bodies of the Joint-stock Companies Owned (Partially Owned) by the State" was also adopted.[27]

According to the Regulation, candidates for boards of directors and executive bodies of joint-stock companies that have strategic importance for the economic security of the republic are recommended by the President of KR according to the Decree of the President of KR "On the Creation of the Stable System of Corporate Governance in KR" of October 22, 1998 and by Prime Minister of KR according to the decision of the KR government "On Improving Corporate Governance in Joint-stock Companies with the State Block of Shares" adopted on August 18, 2003.

The list of companies having strategic importance for the republic is defined and approved in this Regulation. Candidates for positions of chairs and members of boards of directors and executive bodies of joint-stock companies from this list are recommended by the Prime Minister and are approved on the general meeting of shareholders, regardless the size of the State share. When the State is not a majority shareholder, it leads to serious conflicts of interests.

One more instrument (practically not working) is the "golden share."

On the basis of surveys and interviews with specialists it can be said that the role of non-state large owners in KR companies is very great. First, at many joint-stock companies (including the majority of privatized companies) there was no separation between ownership and management – top managers are at the same time the largest shareholders. Secondly, even when these functions are separated, owners have tendencies to directly managing of the company, disregarding the existing laws and procedures. On the other hand, the survey

[27] Amended on January 18, 1999, September 1, 2001, October 11, 2001, and July 8, 2004.

of 2000 showed that in the companies owned by large external shareholders the division of these two functions is greater and official procedures are used.[28]

It is hard to say anything about conflicts between large and small owners, especially taking into account the fact that the latter are mainly employees of these companies and that there are practically no external minority shareholders in the country. The situation inside companies looks quite docile. However, one can expect escalation of conflicts caused by attempts of outsiders to gain control over companies. So far, all the surveys show that hostile takeovers happen very seldom and that in general, the process of ownership "outsiderization" is very slow. Development of market economy will accelerate these processes, so we can expect that conflicts between insiders (who are afraid of losing control over their companies) and potential outside investors will broaden.

3.2.2. Executive body and board of directors

The above-mentioned survey of 2000 shows that the composition of executive bodies in most companies is characterized by high level of reproduction of the elites of the transformed state-owned enterprise. More than 80% of the current members of executive bodies worked in these companies before privatization and about 70% of them occupied managerial positions. In 63% of companies the chairman of the executive body previously was the general director of the same enterprise. In 2/3 of companies there was no substantial change in the managing elite. As it could be expected, most often persons of insider origin occupied the seats in executive bodies in companies with ownership structure dominated by non-managerial employees, and least often — where owners were large external investors. Outsiders occupied averagely less than 20% of seats in executive bodies and in 44% of companies there were no top managers "from outside" at all (see Table 4).

The changes in composition of executive bodies that took place after privatization, were to some extent related to the changes of in ownership structure. Very frequently, when ownership structure changed, a complete change of management happened; where there were no changes in ownership structure, the changes in management bore an evolution character.

The tasks of a board of directors in the system of bodies of a joint-stock company define the specificity of its composition. The function of this body in the Continental model of corporate governance is the supervision of company' activities in the interests of the company and its owners. It doesn't mean that all the main categories of shareholders must send their representatives there or personally participate in its work. In developed countries specialists from various spheres of company's functioning are invited to this body. Frequently,

[28] I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

board of directors becomes the place for coordination of interests of owners and other stakeholders, so representatives of employees, banks, suppliers, and customers can be included there.

Table 4
Composition of the executive bodies and the largest owner (in %)

Position before privatization	The State	External investors	Managers	Non-managerial employees	Total
Worked at the enterprise:	78.2	70.5	85.1	92.2	80.9
1. As a director	20.8	21.7	24.2	18.5	21.7
2. As a vice-director, chief accountant, chief engineer	31.8	22.0	32.6	36.0	30.1
3. Other managerial	18.8	15.7	20.8	23.6	19.5
4. Non-managerial	6.7	11.2	7.6	14.1	9.6
Didn't work at the enterprise:	21.8	29.5	14.9	7.8	19.1
1. Managerial positions at a SOE	9.2	9.3	5.4	1.2	6.5
2. Manager in the private sector	3.8	6.5	2.2	0.4	3.4
3. In state administration	3.1	0.8	1.5	0.7	1.5
4. In local administration	0.5	1.7	0.8	0.4	0.9
5. Private entrepreneur	3.1	2.7	2.3	3.8	2.9
6. Pensioner	-	0.9	-	-	0.2
7. Other	2.1	7.7	2.8	1.3	3.7

Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

In Kyrgyz companies, the formation and further evolution of board of directors' composition were similar to the processes that took place in executive bodies with the only difference that the law provides the opportunity for cumulative voting and election of "their own" members of board of directors. The degree of direct reproduction of elites in boards of directors is lower than in executive bodies but their vertical reproduction (significant percent of members of board of directors who previously were non-managerial employees of the company) is much higher (see Table 5).

Table 5
Composition of the boards of directors and the largest owner (in %)

Position outside of board of directors	The State	External investors	Managers	Non-managerial employees	Total
Work at the enterprise:	45.6	59.0	72.2	74.9	63.1
1 On managerial positions	26.9	34.3	37.5	41.2	35.0
2. On non managing positions	18.7	24.6	34.7	33.6	28.1
Do not work at the enterprise:	54.4	41.0	27.8	25.1	36.9
1. Managerial positions at a SOE	14.9	2.4	6.9	1.5	6.1
2. Manager in the private sector	3.9	17.2	6.3	7.4	9.4
3. In state administration	15.2	1.8	1.0	2.7	4.5
4. In local administration	1.0	-	-	-	0.2
5. In banks	2.0	1.5	-	0.9	1.1
6. Private entrepreneur	1.7	5.3	6.5	6.4	5.1
7. Representative of a foreign investor	1.4	8.0	-	0.9	2.9
8. Representative of the State	12.9	1.9	1.0	-	3.5
9. Pensioner	-	-	1.6	2.4	0.9
10. Other	1.4	3.0	4.7	3.0	3.2

Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

Analysis of the board of directors composition and the fact that the majority of its members (more than 80%) were also the owners can allow us to make two conclusions. First, owners prefer to participate personally in ownership supervision and not to send their qualified representatives there and secondly, the share of interests group representatives not being owners (i.e., stakeholders) seems to be very low. Institution of independent members of the board of directors doesn't practically exist.

The right distribution of functions between these two bodies, including the effective control of board of directors over the work of managers is very important for effective corporate governance. The 2000 survey shows that according to respondents' opinion the most influential group that affects the most important aspects of decision-making are the executive bodies. A high role of the general meeting of shareholders is most often pointed out in the companies where non-managerial employees prevail in the ownership structure. All that is logical in the light of the conclusion made above about the role of owners in management. The board of directors is perceived as the most important body only in a small group of companies, where the main owner is a large external investor (in companies controlled by insiders this body is the fifth on the influence scale).

Table 6
Degree of influence on decision-making process and the largest owner (average value on the scale from 1 – least important to 7 – very important)

Persons and bodies	The State	External investors	Managers	Non-managerial employees	Total
Director (chairman of executive body)	6.39	6.33	6.20	6.59	6.35
Executive body	5.55	6.05	5.78	6.04	5.85
General meeting of shareholders	5.85	5.54	5.70	6.30	5.80
Board of directors	4.73	5.64	4.78	5.26	5.09
Owners of large blocks of shares	4.91	5.31	5.41	4.15	5.03
Employees	4.56	4.40	4.49	5.30	4.63
Trade union	3.15	3.35	2.95	3.31	3.17
Local administration	3.39	2.58	2.50	3.22	2.86
Central administration (ministries etc.)	3.76	2.40	2.19	2.33	2.64
Management of a holding, group, concern (where applicable)	2.44	1.98	1.84	2.08	2.06
Managing group (where applicable)	2.16	2.00	1.93	2.19	2.05
Foreign investor (where applicable)	2.17	2.66	1.55	1.74	2.02

Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

Table 7
Who participates in the most important strategic decisions (in %)

The largest owner	Decisions are made by:					
	Director himself	Executive body	Owner himself	Board of directors	Executive body and board of directors	General meeting of shareholders
The State	21.2	27.3	-	-	21.2	30.3
External investors	12.5	25.0	5.0	2.5	32.5	22.5
Managers	13.0	32.6	6.5	2.2	32.6	13.0
Non-managerial employees	14.8	18.5	-	7.4	14.8	44.4
Total	14.1	25.5	3.4	2.7	26.8	27.5

Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

The surveys showed that the real powers (both formal and existing in practice) of boards of directors at the enterprises under review were broader than the minimum required by the law. At the same time, quite often boards of directors didn't have the powers that were not only rational for this body, but also required by the legislation of KR. On the other hand, the majority of boards of directors were given powers that belonged to other bodies. In practice however, at least in 1999–2000, boards of directors didn't always use the powers granted to them. Even the most important powers were used in less than 75% of enterprises. Of course boards of directors couldn't use some rights during two years as there was no need in them (appointment of top managers, approval of large transactions etc.), but the majority of powers should have been used on the regular basis (see Table 8).

Table 8
Powers of boards of directors of the surveyed enterprises (in % of enterprises where this power is present or is used)

Powers	Powers exist	Powers used in 1999-2000				
		Total	The largest owner:			
			The State	External investors	Managers	Non-managerial employees
Powers that must be taken upon by boards of directors						
Approval of directions of the executive body's activities	80	75	71	72	**85**	64
Agreement to change the terms of activities of the JSC	72	60	54	58	59	**68**
Remuneration of the executive body members	66	57	58	**64**	53	55
Approval of development plans	71	62	58	61	62	**68**
Agreement to change the type of activity of the JSC	66	50	54	**56**	50	45
Approval of large investments	63	48	50	**53**	50	36
Approval of large transactions	69	55	54	**67**	50	45
Approval of merging with another JSC, split	56	43	46	**56**	38	32
Approval of selling and purchasing of shares	57	42	42	36	**56**	27
Supervision and evaluation of the executive body's activity	78	72	**83**	72	62	73
Supervision of owners interests	54	43	25	44	**56**	50
Powers that must be taken upon by other bodies						
Firing and hiring of members of the executive body*	57	46	46	44	**50**	41
Coordination of selling/purchasing of real estate*	73	63	67	**75**	62	50
Coordination of new obligations*	59	46	46	**56**	38	41
Approval of balance and other financial documents	73	72	63	67	76	**82**
Approval of the company' charter	58	51	50	44	53	**55**
Approval of organizational regulations of the JSC	50	40	42	36	38	**50**
Approval of profit distribution	63	58	54	47	62	**73**
Approval of tariff scale	42	36	17	39	41	**50**
Approval of production plans	51	38	37	**42**	41	36
Approval of changes in the authorized capital	68	49	50	44	**59**	45
Supervision of accounts department and documents	62	54	46	58	47	**64**
Supervision of economic activity of the JSC	68	56	**67**	50	53	64
Control of agreements	46	38	29	36	38	**55**
Quality control	41	33	25	31	41	36
Supervision of the implementation of decisions made by the general meeting of shareholders or the executive body	72	62	**67**	61	62	64
Supervision of labor protection regulations	49	37	25	33	**50**	45
Supervision of employees' interests	53	43	33	44	47	**55**

* In some cases these powers can be passed to the board of directors.
Maximum values of the variables for enterprises with different ownership structure are marked bold.
Source: I. Lukashova, G. Freyuk, P. Kozarzewski (ed.), O. Kan, S. Kuklin, *Privatizatsiya promyshlennykh predpriyatiy Kyrgyzstana*.

There were some differences in the use of powers of board of directors in JSCs with different ownership structure. Boards of directors in enterprises characterized by ownership prevalence of:

– the State – were relatively passive;

– non-state outsiders – were generally active in a way relatively most compliant with the Continental corporate governance model;

– managers – were not very active and their activity was oriented mainly on problems of property and management;

– non-managerial employees – were relatively active but their activity, as a rule, was overlapping with functions of other bodies – general meeting, auditing committee and even trade union.

In general, it can be concluded that supervision functions in the majority of joint-stock companies are unsatisfactory. One of the main reasons is the gnoseological one – there was not such a function in state-owned enterprises. Thus, the realization of its importance and specificity of its implementation in joint-stock companies (most of which are privatized SOEs) in most cases proved to be extremely hard. New owners of companies, especially insiders, very often don't understand why the separate supervision should exist when the body that represents owners (general meeting of shareholders) already exists and could supervise the realization of shareholders' interests. At the same time, the interests of a company itself or the use of board of directors as a platform of coordination of interests are for the majority of owners a simple abstraction.

3.2.3. Market of corporate control

This is perhaps the least researched topic in KR. On the basis of some information it can be presumed that this market is not very developed yet. In any case there was nothing in the country that reminded at least slightly, the terse and broad property redistribution that happened in Russia. It can be explained to some extent by lack of really attractive objects in KR. There are no oligarchs (in Russian notion) in the country.

There wasn't also any significant revision of privatization results. But there is a danger that these processes will become stronger after the March 2005 revolution in the process of which there was a takeover of some private and state property. The revolution itself was held under the slogans of revision of the privatization results. So we can expect some commotion on the market of corporate control, although not because of its development and increased "civilization," but because of the lack of consolidation in the reform process.

The main mechanisms of property redistribution are very typical – first of all this is the purchase of stocks from shareholders and very rarely on the stock exchange (because the organized stock market is underdeveloped).

One of the violations of corporate governance principles is the incorrect behavior of registrars of joint-stock companies (e.g., information disclosure and insider trading). In 2004, the "Capital" financial company being the official registrar of the "Promstroibank" commercial bank on the one hand and an interested stock market player on the other hand started to massively purchase shares from minority shareholders of "Promstroibank." Thus having the information about the shareholders of "Promstroibank," "Capital" attempted to perform a hostile takeover. This attempt was successfully blocked, but there were no sanctions applied to "Capital" for these illegal actions.

There were also cases of illegal taking over property by force and change of owner with the help of court and administrative procedures.

The impact of ownership redistribution on disciplining managers is not well researched. It is probably not very big as the property market is shallow, the pressure of potential investors on companies is lacking and there is a widespread combination of ownership and managerial functions in companies. In such conditions managers and companies can easily defy the third parties which try to take over their companies.

Legal methods of protection are very standard and are described above. They are defined by the Acts On Securities Market and On Joint-stock Companies. This is the preemptive right of shareholders to purchase the newly issued shares, mandatory bids, implementation of restrictions on circulation of shares in the charters of joint-stock companies, antimonopoly regulation, etc. Besides, the shareholders of privatized companies are additionally protected by special procedure of re-evaluation of "old" shares after a new issue.

3.3. The role of stakeholders

The role of stakeholders is not legally regulated and is practically very small. Legislation doesn't require the presence of representatives of stakeholders in the bodies of a joint-stock company. But in the process of privatization the role of company's employees was very significant and it influenced the formation of corporate governance in the private sector of the economy. Informal influence of stakeholders on the work of companies is very heterogeneous. In companies where dispersed insider ownership dominates, the informal influence of non-managerial employees is quite strong. In companies with large debts, we can see the substantial role of creditors, who sometimes are able to take over the property. In companies with a large share of the state, formal and informal influence of the state administration is significant.

3.4. Problems of implementation of the corporate governance system

In order for the system of corporate governance to work in full power, a coherent legislative base is needed where all the documents and regulations fit each other. Currently the norms of the Act on Joint-stock Companies contradict many legal acts of ministries and other state bodies, laws of KR and even the Constitution of KR.[29] The lack of precise system of laws' priorities makes aggravates this problem.

[29] E.T. Taranchiev, *Osobennosti primeneniya Zakona Kyrgyzskoy Respubliki "Ob aktsionernykh obschestvakh" i voprosy korporativnoy kultury*, "Pravo i Predprinimatelstvo", 2003-2004.

Members of expert committee of the SCSM in which the most remarkable participants of stock market are included and who constantly face the problems created by the contradictions of legislation, suggested the project of amendments in the Act on Joint-stock Companies. Adoption of the suggestions made by the expert committee would benefit the practice of corporate governance. Besides, experts think that the Act on Securities Market must be revised in order to correspond to the Act on Joint-stock companies as the current corporate governance problems originate mainly from the contradictions between the two laws.

The practice of corporate relations showed that participants of such relations are very reluctant to apply to court. This is due to prolonged procedures of decision-making in such cases and underdeveloped procedures of mandatory fulfillment of courts' decisions. There were some examples, when the newly elected management couldn't start working as the former management, removed from the position by court's decision hindered its work.

According to opinions of many professional participants of stock market, the SPF is one of the largest violators of legislation, which impedes the implementation of effective corporate governance. Its double standards of operation put the legality of many of its decisions under doubt.

In most cases privatization in Kyrgyzstan resulted neither in the better functioning of enterprises nor in their take-over by more efficient owners, due to a distorted institutional and legislative environment and inefficient corporate governance regime:

- ownership structures are not efficient and transparent enough with an excessive role for insiders (managers) and external owners who are tied up with the socialist past; this makes overcoming the legacy of "socialist enterprise" difficult: managers' ways of thinking have been formed in the planned economy, there is a lack of market experience and low corporate governance culture;
- enterprises adaptation to the distorted external institutional and legislative environment has led to the strengthening of non-market behavior (barter transactions, non-payment culture, in-kind wages and salaries, etc), which have been difficult to get rid of subsequently (though recently the role of such behavior has decreased significantly). It is significant that in the middle of the nineties such deviational forms of behavior were very developed in companies owned by non-state concentrated owners, as these firms had the best adaptive capabilities;[30]
- external environment (lack of real estate tax and effective bankruptcy procedures, limitations on a free market turnover of property rights) does not stimulate owners and managers to increase the economic efficiency of their enterprises, including the option of selling them to more effective owners;

- lack of effective separation of ownership, management and supervision functions: owners usually directly participate in the management of enterprises;
- extremely weak and distorted supervision: boards of directors very often play purely a formal role; they represent the interests of the owners only and do not protect the interests of the company as such;
- legal regulation of corporate governance does not define and distinguish clearly enough the functions, rights and responsibilities of enterprise governing bodies;
- weak and distorted role of the state as owner: in fact, the State Property Committee does not exercise effective ownership control of state-owned enterprises and blocks of shares that belong to the state, which leads to the situation of ownership vacuum, informal control of managers and government officials, and asset stripping.

3.5. Non-legislative methods of improving corporate governance

No matter how perfect the legislative base of corporate governance is, the implementation of effective decisions is impossible without some changes coming from outside of the legal sphere. Governments, international organizations, large corporations of the developed market economies came to this conclusion long ago. This problem is very vital in post-Communist countries, especially where there is a complete lack of historical experience in market economy and in private property and legislative base is far from being perfect. In the late nineties in Kyrgyzstan this problem was paid more and more attention.

3.5.1. Efforts "from above:" Support for corporate governance development on the governmental level

In 1997 Kyrgyzstan was given a preferential loan by the Asian Development Bank (ADB) for creation and implementation of corporate governance standards in companies under the project "Corporate Governance and Enterprise Reform." To implement this task, the Center for Corporate Development (CCD) under the apparatus of Prime Minister was organized. The main task of this structure was the development of legislation in the sphere of corporate governance and securities market. The main effect of its work became the project of the Act on Joint-stock Companies, which later was adopted by the Parliament. Besides, the CCD took active part in the development of legislative base for bankruptcy and property valuation.

In 2001 the CCD began the implementation of the second stage of ADB credit line for the program "Corporate Governance and Enterprise Reform." It was supposed to develop the

[30] P. Kozarzewski, J. Kuźma, *Privatiziruyemye i privatizirovannye promyshlennye predpriyatiya Kyr-*

national standards of corporate governance and to start their implementation. The CCD organized intensive trainings with the invited foreign consultants on various questions of joint-stock companies' management, financial management, international standards of financial accounting, strategic planning etc.

In 2004 the credit line was closed, the CCD stopped its operations and all archives were passed to the Ministry of Economic Development and Trade. Unfortunately this archive is not public and it is practically impossible to find any information on the effects of the CCD work.

In the same 2004 the Center for Corporate Development (CCD2) under the Ministry of Economic Development and Trade was founded. The Center is a governmental body responsible for realization of the technical assistance project of the ADB "Capacity Building for Corporate Governance and Bankruptcy Procedures" and the program loan of the ADB "Corporate Governance and Enterprise Reform II." In fact the CCD2 became the follower of the CCD having the following tasks:

- creation of conditions for the development of corporate governance in KR including the OECD principles of corporate governance;
- creation of conditions for development and effective use of bankruptcy procedures in order to increase the vitality of the enterprise sector and financial recovery of the whole economy;
- realization of the ADB technical assistance project "Capacity Building for Corporate Governance and Bankruptcy Procedures" including the fulfillment of the Action Plan for 2004. The Plan was approved by the Government of KR on March 10, 2004;
- meeting the conditions of the ADB program loan "Corporate Governance and Enterprise Reform II;"
- development of the legal base for corporate governance in KR and assistance to joint-stock companies in creating the system of internal acts in accordance with the best practice of corporate governance;
- assistance in creation of favorable investment climate for the stock market, among others, by increasing the number of companies being listed on the stock exchange;
- increasing the transparency of joint-stock companies operations;
- with the help of educational programs, improving knowledge and skills of shareholders, creditors, officials, employees of joint-stock companies and other stakeholders in the sphere of corporate governance, bankruptcy and other problems related to managing a company;
- supplying information for the population on principles of corporate governance etc.

gyzstana.

Despite the broad range of the tasks set for the CCD2, no publicly seen activities can be found now and their website is not updated.

3.5.2. Efforts "from below:" Self–regulating organizations and associations of professional participants of the securities market

The legal base for self–regulating organizations (SRO) in KR is the regulation "On Self–regulating Organizations of Professional Participants of the Securities Market." According to the regulation, SRO is a non commercial voluntary organization. As a rule, a SRO has its ethics code that provides norms for broker and dealer activity.

There are several SROs working on the securities market. In 1998, for example, a SRO status was achieved by the KSE. In 2004 there three more unions of professional participants of stock market were registered: Association of Independent Depositaries and Registrars "Uyum" (13 members), Association of Investment Institutions (10 members), and Broker and Dealer Association (10 members). Professional associations of organizations working in adjacent spheres can also influence the development of securities market and corporate governance. Among them are the Chamber of Tax Consultations, the Union of Accountants and Auditors, and the Union of Kyrgyz Evaluators. One of the main tasks of the above-mentioned public organizations is improvement of legislation that regulates their professional activity and providing consulting, survey and educational services. Currently almost all of them are involved in the development of the new version of the Act on Securities Market."

4. Conclusions and recommendations

4.1. Conclusions

It can be said that there were significant positive changes in the sphere of corporate governance in KR. First of all it should be marked that in the country that had no previous experience of private property and market, institutions of corporate governance were formed. At first they were very formal, but as time went by, they started to be filled with the real contents, especially on a company level. There was a process of learning of both owners and managers how to govern the company using the available set of laws and regulations. It was gradually turning from formal requirement into vital necessity understood by the majority of actors of the corporate governance scene. Apparently the period of confusion after the collapse of the USSR, breaking-off of economic links, and the appearance of the new, unfamiliar environment, is left behind.

But the process is still far from being complete. Despite the adoption of the potentially effective in KR conditions model of corporate governance, the real corporate relations are still very dysfunctional (lack of division of functions, problems with creation of effective owner, etc.). Limited efficiency of the corporate governance development in the country has the following main reasons:

First, this is the material and mental heritage of the "real socialism" – corporate governance develops manly on basis of privatized SOEs and bears the burden of ineffective formal and informal structures and habits formed in the past.

Secondly, reforms are not finished yet: the retaining state-controlled sector is still quite large and the institutional and legal environment in which companies work is still highly distorted. Currently a lot of companies are quickly adapting in order to survive and develop, but they are adapting to the environment that exists now and that is very different from the one in developed countries. Besides, the choice of adaptation methods is limited by the experience, mental outlook, and skills of the main corporate governance players.

Third, the country lacks sufficient sources of knowledge and models of behavior in the field of corporate governance. In the conditions of prevalent insiderized ownership and very low level of foreign investments, especially those from the "first-class," the external (i.e., that emerge outside a company) sources of market mentality and knowledge are virtually absent. The majority of owners and managers have to learn mainly on their own mistakes.

4.2. Recommendations

Improvement of corporate governance in KR requires a complex approach. Improvement of legislation must be accompanied by active measures aimed at improving the situation in all spheres that influence the quality of corporate governance. The main task in this sphere is creation of favorable legal and institutional climate which would lead to improvement of common norms of corporate governance and to attraction of external investments.

Protection of property rights should be strengthened according to the spirit of the implemented model of corporate governance:

- the accent must be shifted from protection of one group of investors (like insiders and minority shareholders) to protection of all groups and types of investors and provision of the transparency of property transactions and their maximum freedom. This will help to redistribute property to more effective owners and to prevent the appearance of oligarchic structures. In order to achieve this, privileges of insiders must be reduced (reducing the right to buy shares in new issues, repealing provisions that stipulate the possibility of restoring previous proportions in the ownership structure after issuing new shares, re-registering closed joint-stock companies as open joint-stock companies or,

at least, determining the maximum amount of the charter capital for the former) and responsibility of shareholders for initiating corporate conflicts must be increased;

- supervision over management of a company should be strengthened. This includes, among others, strengthening the role of board of directors (see below) and precise definition of auditing commission authority;
- additional emission of shares must increase the authorized capital;
- officially proclaimed slogans of equal legal regime for both domestic and foreign investors, their rights and responsibilities must be observed. This means that all current restrictions for foreign investors should be removed, first of all concerning the right for land acquisition and the right for buying certain objects in the course of privatization.

The government must do everything possible to show investors that KR authorities are protecting them, that they protect property rights, creditors' rights and contract enforcement, and that "revolution repartition" of property is stopped and will never happen again and all the objects that had been illegally taken over will be returned to their legal owners.

Corporate governance in companies must be strengthened. First, the functions and powers of a company's bodies must be clearly separated and defined. Secondly, strengthening of the role of board of directors is needed. It must not only exercise owners' control over the company, but also perform a number of other vital functions like in the majority of countries with the Continental model of corporate governance (particularly, to perform qualified supervision of management in the interests of owners and a company itself, and to be a platform for harmonization of various interests). To achieve this, the creation of board of directors in all the joint-stock companies should be mandatory and introduction of the institution of independent members of board of directors is needed.

The culture of corporate governance should be developed in order to overcome the skills and models of behavior inherited from Soviet times and acquired while functioning in the distorted institutional and legal environment of the post-Soviet era. For this purpose, it is important to implement the Best Practices Code where the main principles of properly functioning corporate governance in joint-stock companies would be defined. It should also include concrete recommendations for functioning of a company's bodies. The use of the Code should be voluntary, but a company must declare in its reports and issue prospectuses whether it is going to abide the Code, which regulations of it will be used and not used and why (comply or explain principle). Implementation of the Code will allow not only to improve the corporate governance in companies, but also to increase the transparency of stock market and this, in turn, will give external investors the opportunity to make more effective decisions in capital allocation.

The development of capital markets and provision of their transparency is required. The stock market should be developed in the first place, in order to become a source of financial resources for enterprises, a tool for their market valuation and one of the most important channels of property redistribution. To achieve these goals it is recommended to:

- promote the development of the entire stock market and not only the stock exchange, and strengthen the transparency and property rights protection of over-the-counter transactions;
- turn the stock exchange into a high quality and transparent institution following closely all the standards related to public offerings (this also concerns listings of state-owned minority blocks of shares); at the same time, the KSE should be released from the obligation to take part in over-the-counter transactions;
- stimulate development of institutional investors such as investment funds and (in future) pension funds to create stable demand for securities;
- develop a market for debt instruments (corporate and Treasury bonds, etc.).

Bankruptcy mechanism should be actively used as a method of companies' sanitation. This mechanism must be well thought out and its use must be strictly controlled so that the procedure wouldn't be used for property takeover and redistribution, as it often takes place in many post-Communist countries (e.g., in Russia).

Privatization of state property must be completed and the participation of state in the economy must be radically reduced. The state must not be an entrepreneur. Its revenues must consist of taxes, not dividends and its regulation function must be performed mainly by laws and not by direct management of property. The above considerations call for the rapid completion of privatization which requires:

- removing the majority of existing bans and limitations on privatization, in particular with respect to the majority of infrastructure objects (their privatization should be preceded by demonopolization and changes in regulatory mechanisms), science and culture, alcohol production, gold mining and certain other natural resources industries;
- selling the remaining blocks of shares that are still owned by the state; in the case of low demand (especially, for minority blocks) these shares should be sold through auction without a minimum initial price.

In order for privatization to be successful well-balanced goals should be set, the main of which must be improvement of economic condition of privatized objects (economic goal). This can be achieved by giving property to more effective owners, who are not only the source of investment, but also would lead to improvements in corporate governance and would be able to provide access to new technologies, markets etc. Attraction of effective owners should be done by:

- improvement of the overall investment and business climate;
- granting equal rights to potential domestic and foreign participants of privatization;
- active looking for foreign investors, of the “first-class” first of all – successful and trustworthy foreign and international corporations.

Privatization must be understood as a stable process and its results as the final ones. The latter can be reviewed only in cases of evident violations of the law and under the condition of maximum observance of property rights.

In enterprises with a significant state-owned shareholding (blocking and higher), which are to be privatized in the future but — for various reasons — cannot or should not be sold immediately, a procedure for management buy-in should be applied. In relation to enterprises that are not subject to privatization, one can consider employing experienced foreign managers.

In case of enterprises having a special importance for the national economy, the complete loss of control over which is not desirable, one should use the mechanism of the “golden share” instead of keeping the controlling block of shares by the state. The “golden share” gives the right of veto on the most important strategic issues:

- changes and amendments to a joint-stock company charter;
- reorganization and liquidation of a joint-stock company;
- conclusion of the most important economic contracts, which require the approval of the shareholders’ general meeting according to the company charter;

This right should be exercised at the general meeting of shareholders, and a SPC representative should be elected to the board of directors in an advisory capacity. Using the “golden share” mechanism will placate those who are afraid of losing state control over these enterprises but will limit government interference to a minimum.

Additional measures **for improvement of legislation** that create environment for corporate governance should be introduced. In particular, current contradictions in the law must be removed and the hierarchy of legal acts must be restored in the day-to-day practice.