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Commercial Legal and Institutional Reform (CLIR) Diagnostic Assessment Report for Kazakhstan



A USAID Initiative in Developing Countries

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I. Overview

*"Oh, East is East and West is West,
And never the twain shall meet . . ."*¹

The Kazakhstan diagnostic provides the final component in a four-country study that has assessed the current commercial law environment in Central and Eastern Europe and the New Independent States (CEE/NIS). Each country included in this study—Poland, Romania, Ukraine, and Kazakhstan—was selected for its unique circumstances, including location, geography, size, economic base, legal traditions, and relative progress in transition toward a market-oriented economy.

Kazakhstan sits at an international crossroads, linked to Russia and Central Asia as well as the Indian Sub-continent, China, and the Middle East. Its mineral reserves (oil, gas, gold, and others) generate great interest from Western investors and international policy-makers. At various levels, it is a meeting ground of East and West. The success or failure of reforms can provide valuable lessons for reformers in other transition economies.

Kazakhstan is strongly committed, at the highest decision-making levels, to a market economy and its concomitant reforms. In the few years since independence, the government has adopted numerous new laws, courted foreign investment, and made substantial moves toward a market-oriented economy. One result of this work is that Kazakhstan has the highest level of per capita foreign direct investment of any of the former Soviet republics, including Russia.

A strong president who actively seeks input from the West has led these changes. This attitude is well characterized by his creation of the Council of Foreign Investors, in which representatives of Western multi-nationals and high-ranking Kazakhstan government officials meet regularly to analyze the investment environment and make recommendations for change.

But not all Kazakhstanis are so enamored of the changes. In the hinterlands—at the *oblast* level—there is much resistance to the new rules that come with market reform, though certainly not in all oblasts. Complaints are frequently heard that new laws are "Western" and ill fitting. Foreign investors find poor treatment and unnecessary difficulties in dealing with regional officials. While there is a wide range of reactions to these changes, there is also a wide gap – as the diagnostic shows – between the new "modern" laws and their implementation and enforcement.

Perhaps Kipling was right, that Eastern and Western values do not interface, and Western "plugs" such as laws and market methods will not fit the Eastern "sockets" of communitarian cultural values. Or, perhaps a more universal influence is at work – the power of inertia and the status quo among people who may not understand the options, or among entrenched officials who do not wish to change. These questions will need additional scrutiny before lessons can be easily applied from the Kazakhstan experience; perhaps this diagnostic survey will provide one viewpoint from which to examine the causes of the gap between adopting laws and implementing them.

¹ *The Ballad of East and West*. Rudyard Kipling (1865-1936)



The diagnostic assessment that serves as the basis for this study was conducted in Kazakhstan in June 1999. A team of three expatriate lawyers, supported by local experts conducted interviews and data collection. The diagnostic methodology employed during this assessment mirrored that of earlier assessments conducted in Poland, Romania, and Ukraine.

Broad Indicator	Poland	Romania	Ukraine	Kazakhstan
Population (millions) ²	38.7	22.6	51.2	16.9
Area (km ²)	312,683	237,500	603,700	2,717,300
1997 GDP Per Capita ³	\$6,400	\$5,200	\$3,170	\$2,880
Ave. Δ GDP (1990 – 1996)	3.2%	0.0%	-13.6%	-10.5%
% GDP - Government	18.5	10.1	22.0	12.3
% GDP - Industry	30.7	38.7	40.1	30.4
% GDP - Agriculture	5.1	22.8	12.3	12.9
% GDP - Services	64.2	38.5	47.7	56.8
Foreign Aid Per Capita	\$17	\$9	\$4	\$8
Corruption Index ⁴	4.6	3.0	2.8	--
Credibility Index ⁵	68.05	52.96	>40	48.04
Economic Freedom Index ⁶	2.95	3.30	3.80	4.05+
EBRD Legal Transition Index ⁷	4/4	3/4	2/2	2/2
Moody's Emerging Mkt. Rating	Baa3	B3	B3	Ba3

As indicated by the table of general economic indicators and perception indices above, Kazakhstan ranks behind Poland in all areas, but rates fairly evenly with or ahead of Ukraine. The economy contracted substantially through 1996, though not as badly as Ukraine's. While the government portion of the economy is less than in Poland and Ukraine, the private sector has been unable to increase the overall GDP. Kazakhstan also trails Poland and Romania in credibility, while surpassing Ukraine, but is last in economic freedom. Government may be changing, but the investment in change at the top has not yet percolated through the country as a whole sufficiently to affect these indicators.

² Population Division and Statistics Division of the United Nations Secretariat, 1998 (<http://www.un.org/Depts/unsd/social/poptn.htm>).

³ International Monetary Fund

⁴ Transparency International 1998. Scale = 1 - 10. Higher scores indicate less corruption.

⁵ Euromoney Magazine, December 1997. Scale = 1 - 100. Higher scores indicate greater credibility of government offerings and undertakings.

⁶ 1999 Index of Economic Freedom Rankings, The Heritage Foundation (www.heritage.org). Scale: 1-1.99, free; 2-2.99, mostly free; 3-3.99, mostly not free; 4-5, repressed.

⁷ European Bank for Reconstruction & Development, 1998 Transition Report. Scale = 1 - 4+, where 4+ is most advanced. 1997 and 1998 figures are included. Of those countries included in the Sample, only Romania's score changed between 1997 and 1998.

II. Summary Indicator Results

The summary table below contains the raw Tier I and Tier II indicator results. No attempt has been made to "balance" the four dimensions of this analysis, or give differential weighting to the subject matters areas. For a detailed discussion and analysis of the results, consult the Tier III tables and associated discussion for each subject matter area.

Based on the results of the in-country assessment, Kazakhstan ranks roughly equal with Romania, ahead of Ukraine, and behind Poland in most areas of legal reform. The scores indicate much room for improvement in attracting and maintaining investment and commercial development. Yet, without a time scale, it is easy to miss that these static numbers do not capture the dynamic nature of change over the past few years.

	SUBSTANTIVE AREA	Poland	Romania	Ukraine	Kazakhstan
A.	BANKRUPTCY	78%	54%	37%	50%
	1. Legal Framework	80%	59%	41%	60%
	2. Implementing Institutions	80%	62%	45%	51%
	3. Supporting Institutions	76%	52%	33%	49%
	4. Market for Effective Bankruptcy System	78%	45%	28%	41%
B.	COLLATERAL	77%	32%	48%	35%
	1. Legal Framework	90%	44%	76%	56%
	2. Implementing Institutions	79%	13%	56%	23%
	3. Supporting Institutions	65%	35%	31%	31%
	4. Market for A Modern Collateral System	75%	37%	30%	28%
C.	COMPANY	79%	62%	44%	59%
	1. Legal Framework	81%	63%	47%	62%
	2. Implementing Institutions	76%	73%	52%	67%
	3. Supporting Institutions	82%	70%	42%	58%
	4. Market for Efficient Company Law	78%	43%	33%	48%
D.	COMPETITION	80%	60%	41%	62%
	1. Legal Framework	82%	66%	55%	64%
	2. Implementing Institutions	81%	62%	42%	64%
	3. Supporting Institutions	81%	62%	42%	65%
	4. Market for Open, Competitive Economy	78%	49%	28%	56%
E.	CONTRACT	80%	63%	45%	64%
	1. Legal Framework	83%	74%	50%	73%
	2. Implementing Institutions	83%	73%	49%	66%
	3. Supporting Institutions	79%	66%	50%	54%
	4. Market for Efficient Contract Law	75%	37%	30%	62%
F.	FDI	77%	57%	41%	66%
	1. Legal Framework	87%	96%	89%	83%
	2. Implementing Institutions	82%	58%	18%	68%
	3. Supporting Institutions	66%	38%	28%	50%
	4. Market for Increased FDI	75%	37%	30%	65%

SUBSTANTIVE AREA		Poland	Romania	Ukraine	Kazakhstan
G.	TRADE	68%	54%	33%	52%
	1. Legal Framework	93%	90%	56%	79%
	2. Implementing Institutions	71%	53%	34%	61%
	3. Supporting Institutions	49%	40%	19%	32%
	4. Market for Trade Liberalization	61%	35%	21%	36%
AGGREGATE TOTALS for all areas of law		77%	55%	41%	55%
	1. Legal Framework	85%	70%	59%	68%
	2. Implementing Institutions	79%	56%	42%	57%
	3. Supporting Institutions	71%	52%	35%	48%
	4. Market for Trade Liberalization	74%	40%	28%	48%

Kazakhstan clearly faces the challenge of an implementation/enforcement gap. In most areas, the legal framework is much stronger than the implementing and supporting institutions. Where the gap is smallest—such as Company law with a 67% score for implementing institutions and a 62% score for the law itself—the legal framework is weak. Perhaps this presents a target for reform—using the stronger institutions as a basis for strengthening the framework.

The weakest scores are in the two areas that may have the most significant long-term impact on the availability of credit: bankruptcy and collateral. A well-designed, well-enforced bankruptcy regime permits lenders to assess and control their risks more effectively. Likewise, collateral law permits lower-risk, secured lending. Together, the two laws contribute to the growth and availability of lower cost credit for both business and consumers. The fact that both areas have very low scores in the market for reform suggests that there is a serious gap in understanding the function of these laws, or the benefits they can support. Kazakhstan must surmount the deficiencies in these areas to move beyond self-financed investment and create an environment for broad-based development. Poland, which has much higher scores in both framework and implementation, also has much greater development.

As with all of the countries, Kazakhstan earns a high score for the legal framework for Foreign Direct Investment. Policy-makers want and need to attract substantial foreign capital for the rich mineral industry in this country. The law also targets manufacturing, however, in recognition that commodity development is not enough to support economic development. Even so, scores in those areas that are needed to make investment attractive—collateral, company, and contract—are much too low to support the level of investment desired or needed. The overall diagnostic can be interpreted to suggest that the state is, perhaps, courting foreign money while leaving domestic investors out of the picture. This is not only a questionable economic strategy, it is poor sociology that can fuel xenophobia in the hinterlands.

The legal framework for trade scores relatively high marks with 79%, well ahead of Ukraine (56%) but behind Poland (93%) and Romania (90%). Kazakhstan also has one of the higher scores for implementing institutions, with 61%. (Only Poland scores higher, with 71%; Romania and Ukraine lag far behind, with 53% and 34%, respectively.) Viewed together with the scores for foreign direct investment, a picture emerges of reforms intended to bring Kazakhstan increasingly into the global marketplace, both as a magnet for investment and a crossroads for

trade. Again, the low scores on market (36%) and supporting institutions (32%), indicate that the reforms flow from upper-level leadership, with much work yet to be done in order for the country as a whole to embrace these changes.

Considering Kazakhstan's history of command economy and state controls, the scores for competition are encouraging. The legal framework received marks of 64%, roughly even with Romania (66%), ahead of Ukraine (55%) and, as always, behind Poland (82%). Implementing and supporting institutions are at approximately the same level of development. Internalization of the reforms is likely to take time, but the path seems headed in the right direction.

While Kazakhstan's scores are not stellar, the picture they sketch should not be characterized as bleak. The past two years have brought much positive change, and there appears to be a strong political commitment to continue on this road to reform. Success, however, will certainly require a growth in demand for these reforms at the bottom, not just a supply from the top.

III. Notes on Scope & Methodology

This diagnostic assessment was designed to help achieve the following objectives:

1. To provide a factual basis for characterizing the degree of development and the level of effectiveness of the commercial law reforms initiated in Kazakhstan since independence in December 1991;
2. To provide a methodologically consistent foundation for drawing cross-country comparisons in an effort to identify and describe the root causes of the "implementation/enforcement" gap; and,
3. To provide analytical and planning tools and metrics that will help USAID design new approaches to sustainable, cost-effective C-LIR interventions in the region and elsewhere.

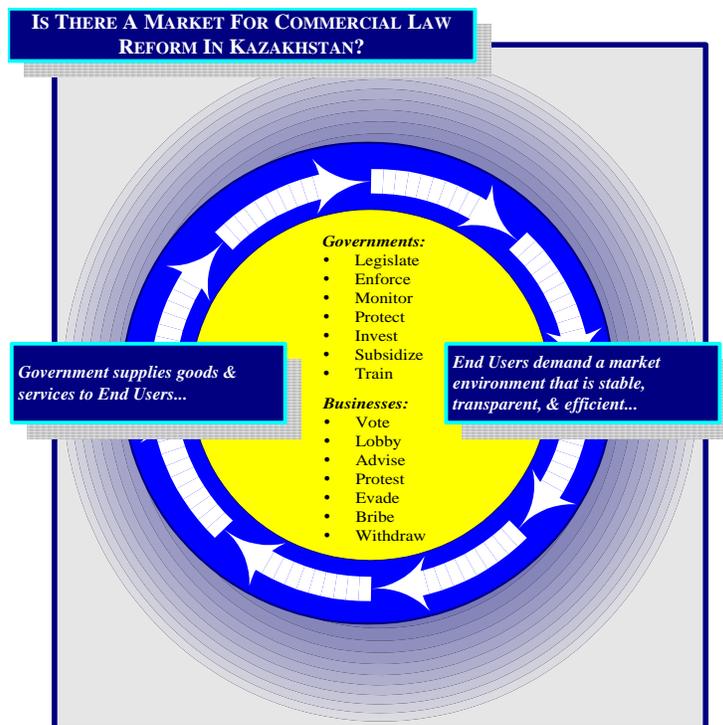
For the purposes of this effort, "commercial law" is defined to include the following substantive legal areas:

- **Bankruptcy** - Mechanisms intended to facilitate orderly market exit, liquidation of outstanding financial claims on assets, and rehabilitation of insolvent debtors.
- **Collateral** - Laws, procedures, and institutions designed to facilitate commerce by promoting transparency, predictability and simplicity in creating, identifying, and extinguishing security interests in assets.
- **Companies** - Legal regime(s) for market entry and operation that define norms for organization of formal commercial activities conducted by two or more individuals.
- **Competition** - Rules, policies and supporting institutions intended to help promote and protect open, fair, and economically efficient competition in the market, and for the market.

- **Contract** - The legal regime and institutional framework for the creation, interpretation, and enforcement of commercial obligations between one or more parties.
- **Foreign Direct Investment** - The laws, procedures and institutions that regulate the treatment of foreign direct investment.
- **Trade** - The laws, procedures, and institutions governing cross-border sale of goods and services.

Each of these substantive areas was assessed by collecting data across the four sample countries. Within each of these substantive areas, four "dimensions" of C-LIR are proposed as a conceptual framework for comparison. These include:

- **Framework Law(s)** - Basic legal documents that define and regulate the substantive rights, duties, and obligations of affected parties and provide the organizational mandate for implementing institutions (e.g., Law on Bankruptcy, Law on Pledge of Moveable Property);



- **Implementing Institution(s)** - Governmental, quasi-governmental or private institutions in which primary legal mandate to implement, administer, interpret, or enforce framework law(s) is vested (e.g., bankruptcy court, collateral registry);

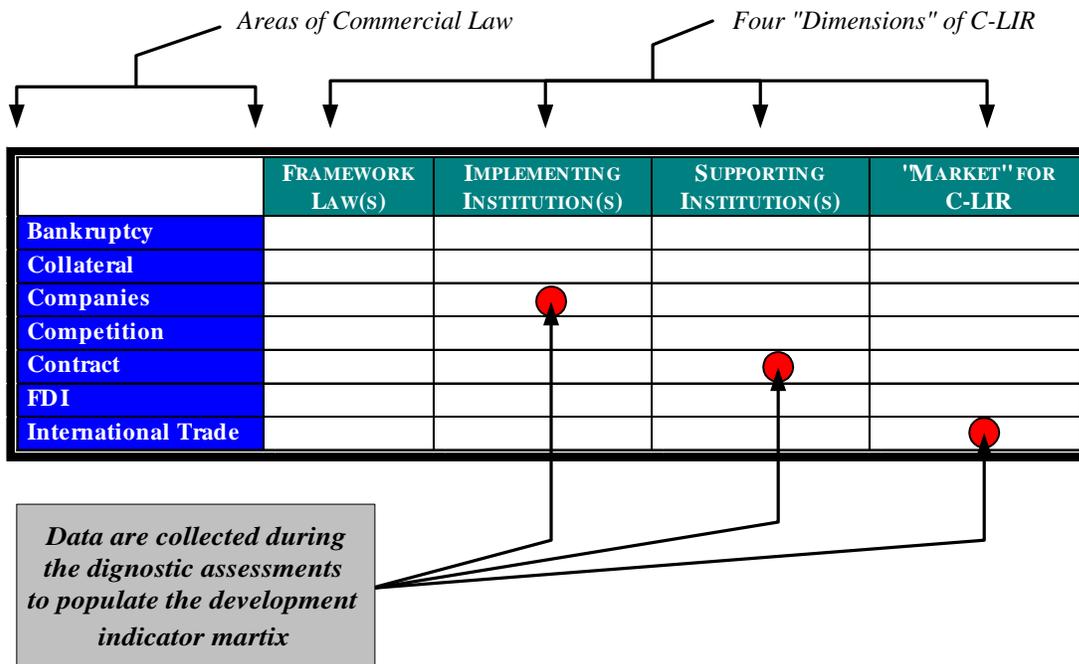
- *Supporting Institution(s)* - Governmental, quasi-governmental or private institutions that either support or facilitate the implementation, administration, interpretation, or enforcement of framework law(s) (e.g., bankruptcy trustees, notaries); and,

- *"Market" For C-LIR* - The interplay of stakeholder interests within a given society, jurisdiction, or group that, in aggregate, exert an influence over the substance, pace, or direction of commercial law reform.



Within each substantive area, development indicators have been defined for each of the four "dimensions" of C-LIR. The figure below provides a conceptual overview of how the development indicators are organized. The twenty-eight "cells" below represent groups of development indicators (or simple propositions) that are designed to provide a "snapshot" of the current state of commercial law reform in each subject area. From a practical standpoint, the diagnostic assessment itself is performed by collecting and analyzing data through published sources, and face-to-face interviews, that are used to populate the development indicator tables.

Conceptual Overview of C-LIR Development Indicators



IV. Interpretive Notes for C-LIR Indicator Tables

Figures 1 and 2 below illustrate how the indicator tables are organized, and can be interpreted. The first example presented is a summary table of "Tier I" and Tier II" indicators for collateral law. The four "dimensions" of commercial law development around which this analysis is organized appear in the left column of table. In this case, the table summarizes the collateral law. The next column to the right ("Ref.") contains a "reference value" (i.e., benchmark) against which the countries in this study will be compared. As indicated, the total score for Country A (228) and Country D (181) in the area of collateral law are to be compared against the reference value for this analysis (400). From this example, it might be inferred that Country A's collateral law system is more advanced than Country D's.

FIG. 1 - TIER I & II INDICATORS

COLLATERAL LAW	REF.	A	B	C	D
Legal Framework	100	85	90	22	64
Implementing Institution	100	72	25	33	47
Supporting Institution	100	34	67	35	49
"Market" for C-LIR	100	37	53	66	21
TOTAL	400	228	235	156	181

4 "Dimensions" of C-LIR

Country Totals = "Tier I" Indicators

Sub-Totals = "Tier II" Indicators

The Tier I and II indicators in Fig. 1 above are derived from the raw data collected in the course of the diagnostic assessments. Tier I indicators provide the highest level of abstraction⁸ and are intended to be the most useful to policy makers and those interested in broad regional comparisons of commercial law environments. Tier II indicators provide an intermediate level of detail, and are intended to be useful in program design and management where diagnosis and resource allocation are key concerns.

FIG. 2 - TIER II & III INDICATORS

B.I.	LEGAL FRAMEWORK - COLLATERAL	REF.	A	B	C	D
1	Law recognizes personal guaranties, either direct or third party, and bank guaranties	10	2	1	3	7
2	Law recognizes non-possessory pledge in tangibles.	10	4	2	5	6
3	Law creates a property interest that allows holder to execute against the security.	10	4	2	5	8
4	Law allows flexibility in the type of security interest created, and nature of the interest secured.	10	10	2	2	4
SUB-TOTAL		40	16	7	15	27

Tier III Indicator "B.1.3"

Indicator Identifier

Tier II Indicator

Reference Value for "Legal Framework"

Tier III indicators provide the bedrock for this analysis. In Fig. 2 above, Tier III indicator values are assigned based on the findings of the diagnostic teams. The Tier III indicators are added to yield the relevant Tier II indicator characterizing the legal framework for collateral law.

As noted above, 7 areas of substantive law are being considered in this study. The three tier approach outlined above, while admittedly complex, is intended to provide both the level of detail required by a specialist; yet the degree of abstraction required by senior program managers and policy makers as they address macro-level issues.

"Yet having begun, we must go forward to the rough places of the law..."

Plato's Republic, Book V.

⁸ Tier I indicators consist of the sum of twenty-eight Tier II indicator values (i.e., four "dimensions" each for 7 substantive areas of law under consideration) for each country analyzed.

V. Narrative Summary of Diagnostic Findings

A. Bankruptcy Law

Legal Framework

Kazakhstan's bankruptcy law has undergone constant change and fine-tuning in recent years but is still far from perfect. When it was adopted in 1997, the Law on Bankruptcy⁹ was praised as breakthrough legislation in Kazakhstan and the Commonwealth of Independent States (CIS). Unlike the prior law,¹⁰ which gave few protections and rights to creditors, the new law adopted the traditional structure of bankruptcy legislation used in Western countries and laid out a relatively coherent set of procedures.

Since its enactment, the law has already been amended three times: on July 11, 1997, July 1, 1998, and July 10, 1998. Not all the amendments are considered improvements. There is widespread sentiment that the Bankruptcy Law, which governs a complex field, is more complicated than necessary, resulting in much misapplication in practice. This trend in complications seems to be continuing in the wrong direction, with one of the implementing institutions currently proposing twenty-four separate amendments.

Even so, the law has set out the ground rules for bankruptcy. Based primarily on a Western model, the law adopts the binary "liquidation or rehabilitation" options. In this approach, the courts supervise the collection of information sufficient for creditors to decide whether the company should be liquidated or rehabilitated. If the company cannot be rehabilitated within 2.5 years, it is declared bankrupt.

Filing of bankruptcy creates a moratorium on debt repayment, allowing the debtor company to attempt rehabilitation. In addition, the law permits some flexibility in negotiating by permitting extra-judicial settlements directly between the debtor and creditors, although the scope of such agreements is limited.

Creditors may initiate bankruptcy proceedings by showing that the debtor is 90 days overdue on debt of more than "150 minimum monthly salaries." Creditors may combine their claims to meet the size-of-claim requirement. Once a proceeding has been initiated, the law prohibits the debtor from disposing of or transferring its assets. This can be an important tool for a creditor who is trying to stop the debtor from selling assets in a non-competitive sale.

Despite improvements in the law, all too often debtors succeed in defrauding shareholders and frustrating creditors' rights. The typical pattern is for management of a large state company to file for bankruptcy after the company has been run into the ground. Although there is a voidable preference period of one year in Kazakhstan, fraudulent or illegal "anticipatory" transfers are infrequently stopped or voided. Thus theory and practice have not sufficiently intersected.

⁹ *The Law on Bankruptcy*, [Law No. 0256], adopted January 21, 1997.

¹⁰ *Decree of the President "On Bankruptcy"* of April 7, 1995.

Debtors also take advantage of an overlap between the new Bankruptcy Law and retained provisions of the Civil Code which continue to deal with bankruptcy. Before the new law took effect, owners of many companies initiated voluntary liquidation proceedings under the articles 50 and 51 of the Civil Code. They filed for liquidation, appointed themselves (or their friends) to serve on the liquidation commission, and controlled the proceedings in such a way as to favor their own interests and those of selected creditors. The end result was that most of the creditors (including the Tax Inspectorate) ended up with nothing.

This practice still exists, but it has been greatly curtailed. The law is now clear that Civil Code liquidations are intended only for debtors who can pay all their debts. When the assets of a company are insufficient to pay off the company's debts, the Civil Code recognizes that a liquidation under bankruptcy proceedings is the appropriate route.

The shift from Civil Code to Bankruptcy Law proceedings is not self-executing, however. Instead, a creditor must initiate the change. In practice, this occurs when a creditor reads in the newspaper that a debtor has initiated a liquidation under the Civil Code, and responds by commencing the proper bankruptcy petition with the court. Of course, if a creditor does not sufficiently monitor the newspapers or court proceedings to learn that a Civil Code liquidation is underway, then debts may be seriously compromised or extinguished, just as happened before the new bankruptcy law was enacted. Further changes are needed to close this loophole.

Another problem area is that the bankruptcy of "individual entrepreneurs" is governed by Article 21 of the Civil Code while the bankruptcy law only applies to legal entities. Individual bankruptcies are universally related to business dealings (non-commercial bankruptcy is not recognized), so that this situation could be handled through the Bankruptcy Law. Selection of law based on the nature of the party seems to be a holdover from the communist period.

It would eliminate much current confusion in the law if the retained bankruptcy provisions in the Civil Code were harmonized with the bankruptcy law and both laws were consolidated in a single piece of legislation. Just to highlight one obvious point: there is no reason why bankruptcy and Civil Code liquidations should not be governed by a single standard of actual notice to known creditors and constructive notice (through newspaper advertisements) to unknown creditors.

Despite its imperfections, the existing Legal Framework for bankruptcy is still far better than Ukraine's and is comparable to that found in Romania. This is apparent from the numerical scores attached to the Legal Framework indicators attached to this report.

Implementing Institutions

There are two implementing institutions for bankruptcy in Kazakhstan: the courts and the Agency for Restructuring and Liquidation of Enterprises ("Agency") within the Ministry of State Revenue. By far, the courts play the more important role.

Under the Bankruptcy Law, jurisdiction over bankruptcy cases is vested in the Commercial Law Collegium at both the Oblast and Supreme Court level. This is the successor to the *Arbitrazh* Courts under the former Soviet system. Currently, these courts only have jurisdiction over legal

entities, although consideration is being given to merging the Commercial and Civil Collegia and eliminating the practice of having the nature of the party determine the jurisdiction of the court.

Either a debtor, or a creditor, or certain third parties may initiate a bankruptcy by filing a petition with the Commercial Law Collegium in one of Kazakhstan's fourteen Oblast or two city courts. Once accepted, all claims against the debtor are consolidated within the bankruptcy proceeding.

Over the next three months, the parties submit documents that clarify to the court (a) the indebtedness of the debtor, (b) the State interest in delaying proceedings for various public policy reasons (for example, privatization, adoption by the Rehabilitation Bank, or the role of the debtor as main employer in a company town), and (c) any interest in and the likely outcome of a rehabilitation attempt. The court then holds a hearing to decide whether to liquidate the company, dismiss the case, allow rehabilitation procedures, or allow more time for considering rehabilitation. If the debtor can demonstrate that it is able to pay off its debts, the court may dismiss the case. If there are no petitions for rehabilitation or if either the secured or general creditors reject the petitions, liquidation proceedings begin. The court appoints a liquidator (usually with the consent of the creditors) who musters assets, considers claims, sells the debtor's property, and distributes proceeds. The company is then removed from the list of legal entities kept at the Ministry of Justice.

If the secured and general creditors each (by voting separately) agree to rehabilitation, then the court appoints a rehabilitation manager (approved by the creditors) who has approximately two years to put the company back on its feet. If this effort is unsuccessful, then liquidation proceedings begin.

The Agency, in contrast, is not a statutory body and has rather circumscribed functions. It represents the interests of budget creditors and initiates extra-judicial bankruptcy proceedings. In addition, the Agency maintains statistics on bankruptcy cases, arranges training for bankruptcy professionals, seeks and attracts foreign investors, and is charged with making recommendations to the Government to increase the effectiveness of bankruptcy procedures.

According to Agency statistics, 5,694 enterprises were included on the Insolvent Enterprises Register as of June 1, 1999. This compares with 4,591 enterprises at the end of 1998. Of these amounts the vast majority of companies are destined for liquidation. Examining the most recent statistics, rehabilitation procedures were applied to only 99 enterprises, while a further 37 are in the process of court examination. By contrast, 820 enterprises were already liquidated, 2,470 are pending liquidation, and 1,616 may be recognized as potential bankrupts. Another 439 of the companies were dropped from the insolvency rolls and resumed normal operations. To complete the picture, 213 were involved in court procedures.

In the case of companies being liquidated, the vast majority of liquidations are handled through judicial proceedings. This reached 85% in the most recent statistics. In recent years the percentage of liquidations handled through non-judicial proceedings has been consistently dropping. There were 26% fewer non-judicial bankruptcy proceedings from March to August 1999.

It should be recognized that many of these bankruptcy cases involve companies that have literally no assets and are only fit for liquidation. In many situations, management has stripped the companies of assets and then declared bankruptcy. As a result, many companies lack sufficient property to meet even creditors' claims of the first order of priority – namely labor “invalids” (valid Workers' Compensation claims). Agency statistics show only 40 cases of deliberate (intentional) or fictitious bankruptcy, but the real number can be assumed to be much higher.

Supporting Institutions

From an institutional point of view, the role of the courts as implementing institutions must be supplemented by a community of experts who understand the bankruptcy process and can effectively implement the bankruptcy laws. This community is a supporting institution for purposes of this diagnostic. It includes trustees, clerks, appraisers, liquidators, crisis managers, bankers, lawyers, etc. – all of whom should be willing and eager to implement the bankruptcy laws.

In Kazakhstan the law designates three types of representatives to protect the interests of the creditors once a company enters bankruptcy proceedings: an administrator, a rehabilitation manager, and a liquidator. The administrator is initially appointed by the court to watch over the company until the creditors can meet. If the creditors decide that a rehabilitation is appropriate, then they choose a rehabilitation manager. If they choose liquidation, they appoint a liquidator.

The bankruptcy law adopted in 1997 required that creditor representatives be trained and licensed. Over 1,500 liquidators, rehabilitation managers, lawyers, economists, and others were trained in two-week bankruptcy training courses offered by three training entities in different urban centers during the past few years. Over 90% of the trained liquidators were licensed as rehabilitation managers as well.

However, the licensing requirement was eliminated in the July 1998 amendments of the law. As one of its 24 proposed amendments to the law, the Agency is urging that this requirement be reinstated, arguing that this is the only way to ensure that bankruptcy professionals meet necessary standards of ethics and professionalism. Skeptics argue that the Agency's position has more to do with the monopoly power that it seeks over the selection of this lucrative class of functionaries rather than any deep-seated desire to improve the system. Kazakhstan is a heavily (over) licensed society which serves the purposes of rent-seeking bureaucrats.

Whatever position one takes on this debate, there is no doubt that liquidation and rehabilitation managers leave much to be desired on the ethics and professionalism front. They often abuse administrative costs through high salaries, inflated staff levels, kickbacks from auditors, etc. The Agency's position is that there should be statutory norms for the compensation of liquidation managers, staff levels, and operations. The Agency also argues that liquidation managers should be given performance incentives to keep costs down and maximize the return for creditors. These changes are included in the legislative proposals offered by the new director of the Agency.

The attached Development Indicators show that supporting institutions for bankruptcy in Kazakhstan are more advanced than in Ukraine though are somewhat behind Romania's. These institutions are embryonic, however, and still well below any acceptable standard.

The "Market" for Bankruptcy Reform

In a demand-driven commercial economy, successful suppliers will adapt their goods and services to meet demand. When supply does not respond to demand, the market will be less robust. This is equally true in Kazakhstan's market for legal reform. In the field of bankruptcy, the market is not thriving.

Clearly, there is demand for a system to deal with failed or failing companies. Registered insolvent enterprises have grown almost 24% in the first six months of 1999, up to 5,694 from 4,591 in late 1998. The demand, however, is coming from two separate sources. On the one hand, some government officials, often at the insistence or influence of foreign donors and lenders, are demanding a new regime to relieve the state of its historical role in paying for bailouts. On the other hand, local "consumers" – creditors and failing companies – have different demands, with a strong preference for a continuation of state bailouts.

In response to this bifurcated demand, there has been a bifurcated supply. Kazakhstan has adopted Western-style bankruptcy laws that could potentially be very effective for rehabilitation and proper liquidation of troubled enterprises. At the same time, however, the state continues to prop up and bail out some companies. Consumers thus have an option, and so far tend to prefer government funds and guarantees to the less certain results of negotiated settlements under the bankruptcy regime. As long as bailouts are available, the demand for formal bankruptcy proceedings will be diminished, and improvements to the system will be delayed, which will further lower the demand.

On the supply side, there are problems both with the substance and the process of the law. Practically everyone with whom the team visited had an unkind word to say about the existing Bankruptcy Law. Even those people who generally favored the law argued that it was unnecessarily complex, hard to understand, too much of an import from the West, and inconsistent with other laws. Frequent changes (one critic argued that essentially there have been four bankruptcy laws in the past two years) made it hard to keep up. Almost certainly, more changes are on the way, but there is no assurance that they will be changes for the better. Existing demand is for a user-friendly law, which is not currently being supplied, resulting in a low level of enthusiasm for bankruptcy as an institution.

Ideals held-over from the Soviet period also affect supply. There are still many in Kazakhstan who do not believe that a company should be allowed to go bankrupt, but should instead be bailed out by the state. This school of thought diminishes demand for a bankruptcy regime, thus impeding the development of a genuine institutional framework that regulates how under-performing and non-performing enterprises *exit* the marketplace. Banks and other creditors will not vigorously enforce their rights under bankruptcy legislation unless they are convinced that state bailouts are unavailable. Once bailouts are no longer an option, the demand for coherent bankruptcy laws will increase.

Reacting to imperfections on the supply side of the ledger, banks, and the private sector have not devoted much attention to the rehabilitation aspects of bankruptcy. Of course, liquidating defunct, asset-bare, State companies is not controversial. But bankruptcy has yet to fulfill the efficient market-clearing mechanism that it does in the West. Weaknesses in the institutional framework of bankruptcy have added to the ambivalence about it. There is a widespread feeling that the law is not understood by the legal community or properly applied in practice. In other words, the supply of bankruptcy law and services is perceived as low quality. Consequently, there is little demand for these services.

Although far from dynamic, a community of bankruptcy experts may be starting to take shape. Fifteen hundred professionals undergoing bankruptcy training is a considerable number. There have been some early signs that creditors, lawyers, and accountants are starting to organize themselves to advocate and lobby for improvements in the law. Experience in other transition economies shows that as the pace of reform quickens, new interest groups form and the policy agenda becomes more extensive. Liberalization of the business environment can be a powerful catalyst, setting off a virtuous cycle where each reform makes the next one easier.

Once the government relegates bailouts to the past, demand will have to focus on the bankruptcy regime. It is expected that creditors will then become much more serious about proper enforcement of rational laws, and the framework will be refined and improved in keeping with local needs.

B. Collateral Law

Legal Framework

Collateral law in Kazakhstan seems to be a case of arrested development. Although framework legislation has been enacted,¹¹ it lacks the necessary implementing regulations to make the pledge registry a reality. Such regulations have been drafted and were even considered by the Government during November 1998, but they have been left on the table. There seems to be no momentum in Kazakhstan to push collateral law forward at this moment.

The inertia is in part due to priorities (demand) and in part to perceptions of quality of the law adopted, leading to a lack of enthusiasm shared by foreign advisors and Kazakhstani alike. On the priority side, many of those potentially affected simply feel that pledge registry is secondary to real estate registry, which does not yet exist. Few understand the role of collateral in increasing the quantity and quality of credit. Consequently, establishing the collateral registry is not a high priority.¹²

In addition to low demand, the law is considered both redundant and deficient. The team frequently heard arguments that collateral pledges were adequately dealt with by Article 308 of the Civil Code, and thus there is no need for the 23 new articles under a separate new law. These potentially supportive groups generally find insufficient benefits to justify changing to the new law.

In Western eyes, the law is deficient because it does not provide for filing adversarial liens by pledge holders in cases where the collateral is transferred to a third party. Moreover, there is no clear liability for persons who dispose of collateralized property without the consent of the pledge holder. Thus the lender's security interest is not sufficiently protected.

The collateral law does improve upon the prior regime, however. It applies equally to physical persons as well as legal entities – solving an earlier problem with the draft bill. The law clearly establishes the registration date for determining the priority order of claims. (It is a "race notice" statute.) The registration system seems simple and workable. The law limits the circumstances under which a pledge can be refused registration. And registered pledge holders have a high priority in bankruptcy court.

On the whole, the legal framework has been improved through recent reforms, but not sufficiently. It is doubtful that there will be much additional reform until there is better understanding of the benefits of a collateral lending system.

¹¹ *The Law on Registration of Pledges of Moveable Property [Law No. 254-1] of June 30, 1998.*

¹² Many view a collateral registry as a matter of secondary importance. To them, the *real* pledge problem relates to *immovable* property. Currently there is no legal pledge registry mechanism for land. Under current law it is possible to give a mortgage on a building together with the underlying land, but not on land alone. Land titles will not be issued until the necessary cadastral register is prepared. Several interviewees said that once the land registration problem was solved there would be time enough to tackle collateral pledges.

Implementing Institutions

As already noted, Kazakhstan has not yet enacted the regulations necessary to establish the implementing institutions for collateral registration. The framework law simply provides that agencies for registration of pledges of moveable property are “organizations operating under the jurisdiction of the Ministry of Justice...as well as other state agencies and legal entities authorized by legislative acts to register certain types of moveable property...and pledges of such property.”

This is a mouthful, and a very unclear one at that. The Ministry of Justice will undoubtedly play a key role in collateral registry, but exactly which agency under the jurisdiction of the Ministry of Justice will be charged with this responsibility is impossible to say. There are currently three agencies charged with some form of pledge registration: the Immovable Property Registry (which registers security interests in buildings and the underlying land); the Motor Vehicle Administration (GAI) (which includes registration of pledges on automobiles, but not tractors, farm equipment or other off-road vehicles); and the Share Depository at the National Securities Committee. It is quite possible that collateral registration will be handled by an entirely new agency.

Where the underlying property is *not* subject to mandatory registration, there is no existing uniform registry system. A partially effective system has evolved to fill this need: creditors sometimes register pledges with a notary. This gives the pledge holder minimal protection by placing others on notice as to the existence of this security interest, but only with that notary. Debtors can (and sometimes do) register a new pledge on the same property with a different notary and thereby frustrate the interests of the first lienholder.

To summarize, existing pledge registration functions are divided among several entities. It is unclear at the moment whether this practice will be continued (with expanded powers for one or more of the entities) or whether functions will be consolidated in a single collateral pledge registry. Until implementing regulations for Law No. 254-1 are adopted, there will be no Implementing Institutions.

Supporting Institutions

The Supporting Institutions for Collateral Law are the courts and the enforcement agents (bailiffs) who execute judgments against pledged property.

The Legal Framework and Implementing Institutions for collateral law are so imperfectly developed in Kazakhstan that the Supporting Institutions have had scarcely any opportunity to respond. The number of cases that come before the courts in the collateral law area are miniscule. The head of the Commercial Collegium in the Supreme Court reports that considerably less than one percent of the commercial cases involves pledges. Not surprisingly, enforcement agents have very little to do with pledged property.

In Collateral Law, Kazakhstan has the lowest score of the four countries studied for Supporting Institutions.

The “Market” for Collateral Law Reform

As is evident from the above discussion, the “market” for Collateral Law reforms in Kazakhstan is extremely weak.

To many Kazakhstani jurists and lawmakers, the collateral law is just another import from the West that is not really needed or relevant to Kazakhstan. Ideally, the demand for collateral law should begin with investors (whether corporate or individual) who can borrow against the value of their movable property, and lenders, who can lower their risks of loss by ensuring against default through security interests. When properly constructed, collateral law improves the quantity (more loans) and quality (better terms) of credit available.

Demand for a collateral regime is weak in Kazakhstan. This is due to several reasons. First, demand for this type of reform is often led by creditor institutions. However, there is very little pressure on Kazakhstani banks to enter this area of finance. They are currently concentrated on trade finance with its high interest rates and quick returns. This has diverted the banks from developing a system for commercial project lending.

To the extent that banks and other lenders do get involved in project lending, they have developed survival strategies outside the practice collateral use. Commercial banks require bank guarantees and personal guarantees, either direct or third party. Lenders take mortgages on commercial buildings and personal residences as security. According to officials at one bank, collateral pledges are mostly used to secure loans by individuals, whereas companies normally pledge immovable property.

From the perspective of the small business community, however, the demand profile is much different. This group is definitely seeking more credit and project finance. This group would normally serve as an engine for creating a collateral system or reforming the existing law. In Kazakhstan, however, the importance of Collateral Law as a way of achieving this objective is scarcely recognized. Hence practically no one is urging vigorous Collateral Law reform at the present time.

It is not surprising, then, that there is little interest in Collateral Law reform at the government level. In some ways, this can be seen as a positive situation: representative government should generally respond to the demands of its constituency; there is no demand for a collateral pledge system, therefore, government is utilizing its limited resources more in accordance with perceived need and not taking a paternalistic approach. Indeed, without an expressed need for such reform, it is unlikely that any law supplied will adequately address local realities and more likely that paternalism will shape the framework, requiring additional reform once demand has developed.

In short, Collateral Law reform in Kazakhstan is ahead of the game. There is virtually no demand for it, and, as a result, no supply.

C. Company Law

Legal Framework

Kazakhstan has undertaken substantial reforms and improvements in its Company Law framework. In 1998, the government adopted the new Law “On Limited and Additional Liability Companies” dated 22 April 1998 and the Law “On Joint Stock Companies” dated 10 July 1998.

Today, Kazakhstani law recognizes the following types of legal entities:

- General partnerships;
- Limited partnerships;
- Limited liability companies;
- Additional liability companies; and
- Joint stock companies.

These entities are generally established pursuant to a foundation agreement (for more than one participant or shareholder) and a charter. The foundation agreement governs the rights and obligations of the founders prior to incorporation or establishment. Once incorporated or established, the charter generally governs the rights of participants and shareholders. The foundation agreement only governs disputes between the founders.

The limited liability company (“LLC”) is the most frequently used business vehicle in Kazakhstan. An LLC is a company established by one or more physical or legal persons, not to exceed fifty. The foundation agreement sets forth the participation interests that the members must contribute toward the charter capital. Participant liability for LLC obligations is limited to each participant's charter capital obligation, allowing participants to define their level of risk at the outset.

The joint stock company (“JSC”) is expected to become an increasingly popular organizational form for many legal entities doing business in Kazakhstan as a result of the new Law on Joint Stock Companies. The law creates a framework for private sector companies that is familiar to western businessmen and lawyers. The law contains protective clauses for investments in circumstances that have the greatest potential for abuse, such as:

- additional share issues;
- maintenance of charter capital and restrictions on payment of dividends;
- re-purchase by companies of their own shares; debt to equity conversions;
- conflicts of interest for company officers;
- proxy votes;
- independent audits; and
- determination of asset value during sales of company property.

A JSC is a legal entity that issues shares in order to raise capital for its activities. Shareholders of a JSC are not liable for the obligations of the JSC and bear the risk of loss only to the extent

of the amount the shareholder agrees to subscribe for shares. At the time a JSC is formed, the founders must elect whether it will be open or closed. The number of shareholders in a closed JSC may not exceed 100. Shareholders in a closed JSC have a preemptive right to acquire the shares of other shareholders.

An open JSC may have an unlimited number of shareholders who have the right to dispose of their shares without the consent of other shareholders. If an open JSC meets the following three tests, it will be a “public” open JSC: (i) its shares are quoted on an organized securities market, such as the Kazakhstan Stock Exchange; (ii) its assets are worth at least 200,000 times the monthly calculation index (MCI) or approximately \$1,250,000; and (iii) it has at least 500 shareholders.

These laws also set forth important provisions in the areas of fiduciary duty and minority-shareholder rights. Among other items, the law gives shareholders a legal right to sue to stop or seek redress for actions that constitute a violation of law or the company charter. Some of the more common abuses are:

- Diversion of business to another company in which the majority shareholder holds a greater interest.
- A majority shareholder awarding himself excessive financial benefits.
- The asset-stripping of controlled or related companies by the majority.
- A share issue offered on a pro rata basis at a manipulative price in the knowledge that the minority shareholder will be unable to buy.

The right of redress for such abuses is limited to situations in which there is a breach of law or the company charter. There is no concept of “unfair behavior” for which a court might intervene on the basis of equitable principles. Thus, a Kazakhstani minority shareholder cannot intervene simply because a majority shareholder obtains excessive rewards -- which is not illegal -- unless the charter forbids such actions. Likewise, dilution of minority shareholding (which is not always illegal even in protective Western jurisdictions) and asset stripping are not illegal per se, leaving minority shareholders exposed to risks that should be more explicitly covered by law.

The existing laws are decidedly steps in the right direction and are better than the laws that they replaced. In addition to the weaknesses in protecting minority shareholders, however, there are provisions of both laws that have businessmen and lawyers concerned. Clearly the most serious of these provisions is the notorious Chapter 5 of the Law on JSCs entitled “Additional Shares Issued Pursuant to a Court Decision.” This chapter is intended to give the State a creative way to collect back taxes from delinquent JSCs without forcing them into bankruptcy proceedings. Briefly, it allows the State, with court consent, to force a JSC to issue new shares to new shareholders, the proceeds of which are applied to satisfy back taxes and other overdue payments to the budget.

There is a strong fear in the foreign business community that the State, by asserting an arbitrary, excessive tax claim, could use this legal authority to, in effect, reverse a prior privatization should the company prove profitable and the government want it back. (This fear is magnified by an anomaly in the tax code, requiring payment of taxes on payables without any offset for

uncollected payables. In other words, the tax code requires tax on amounts invoiced, *whether or not* the invoices are ever collected.) This law reflects a serious lack of understanding by the Kazakhstani authorities of what a JSC is and how it should operate in relation to shareholders, creditors, etc.

Another controversial provision of the JSC Act is Article 22(4), which allows the founders of a company to be granted a “golden share” giving the holder “the right to veto resolutions of the company’s bodies on the issues defined in the company charter.” Although the “golden share” does not participate in the formation of charter capital or receipt of dividends, this right of veto over an ongoing company’s operations has raised alarm bells with investors both foreign and domestic. It is used frequently in privatized companies, allowing ongoing -- though limited -- government control even after privatization.

Lastly, Article 27 of the Law on LLCs requires notification of all creditors when there is a reduction of charter capital and then gives creditors the right to accelerate their debts. Although this provision seems strange in the U.S. context, it is a quite common feature of the European approach to company law which regards the minimum stated capital as the special preserve of creditors. In keeping with this approach to company law, it is not illogical to allow the creditors to accelerate their loans whenever the company’s capital falls below their comfort level.

Although not strictly part of the Company Law legal framework, licensing legislation in Kazakhstan establishes an extensive list of investment activities requiring licenses and permits. By law a license is granted without discrimination to any entity that satisfies the requirements for that specific license. Thus, foreign investors may obtain licenses on the same conditions and in accordance with the same procedures as Kazakhstani nationals. Despite this equality, foreign investors fear that they may be the targets of legal and extra-legal harassment – particularly if they find themselves in a minority position in a company.

The Legal Framework for Company Law in Kazakhstan has made important steps forward in recent years. Kazakhstan is considerably ahead of Ukraine and not far behind Romania in the Development Indicators in this category.

Implementing Institutions

Company registration is under the oversight of the Ministry of Justice, which has established territorial bodies throughout Kazakhstan for this purpose. These registering authorities are considered the Implementing Institutions for purposes of this report.

Until recently, a major problem in the overall Company Law framework was the complexity, cost, and corruption involved in registering a new business in Kazakhstan. The simple act of officially registering a business grew into a complicated multi-stage procedure requiring extensive time, money, and influence. This situation created a difficult barrier for small entrepreneurs struggling to find a place in the marketplace, as well as unnecessarily raising the costs of incorporation for wealthier, better connected investors. Fortunately, these problems have been mostly corrected.

After years of mounting complaints from domestic and international business groups, combined with pressure from the World Bank, the Government simplified the business registration procedures. Under Edict 2198¹³ of 1995, new procedures came into force. In essence they mandate that the state registration of “a legal entity should be made no later than 15 days, and for small business no later than three working days from the date of submission of an application.” The documents required to support an application are clearly stated in the Edict. Should the authorities refuse registration, the reasons for the refusal must be stated in writing, thus creating a basis for appeal or protest based on law.

Under article 5 of the Edict, the Ministry of Justice carries out:

- Registration of legal entities and management of the State register of legal entities.
- Oversight of the “territorial bodies” that handle company registrations.
- Preparation of a quarterly report on new registrations of legal entities and of those that ceased activity during the quarter.
- Consideration of and acting on complaints leveled against the territorial bodies.

Thus, each LLC, JSC, and other legal entities must be registered with a territorial body of the Ministry of Justice. These offices are located throughout the country. Information including the name, address, charter capital, names of the founders, and members of the executive bodies are recorded in the State register of legal entities. The fee for State registration of an LLC or JSC is equivalent to twenty times the MCI as of the date of submission of the documents for State registration, or approximately \$125.

In order to establish a legal entity, the following documents must be submitted to the registering authorities of the Ministry of Justice:

- Application,
- Charter,
- A document confirming payment of the State registration fee,
- If one of the founders of the JSC or participants in an LLC is a foreign legal entity, a certificate of registration/good standing from its place of registration.

After registration is completed, the legal entity must complete additional post-registration requirements, including requirements to obtain a tax registration number and register with various social funds.

According to numerous lawyers, bankers, businesspeople, and business-related NGOs that the team interviewed, the earlier problems associated with company registrations have largely been corrected. Practically every person interviewed said that creating a legal entity in Kazakhstan was not a particular problem. The numerical scoring that Kazakhstan receives in this area reflects this improved situation.

Supporting Institutions:

¹³ *Edict of the President With Force of Law No. 2198 (“On State Registration of Legal Entities”) of April 17, 1995, as modified on August 31, 1995, July 15, 1996 and June 19, 1997.*

In the West, business associations, lawyers' associations, universities, foundations, and even think tanks are key participants in the public policy dialogue that leads to improved corporate governance and protection of shareholder rights. This support structure for Company Law is at a very early stage of development in Kazakhstan.

One consistent advocate for change in the area of Company Law is the Foreign Investment Council - jointly composed of representatives of the Kazakhstani authorities and foreign investors. As further described in the section on Foreign Investment, the Council has proven itself an important voice in how laws are structured and enforced. The comparable body on the domestic side is the Forum of Entrepreneurs of Kazakhstan. With over 2,000 members mostly drawn from the private sector, the Forum is starting to play a more active role. By and large, though, Kazakhstani entrepreneurs are more reconciled to the status quo than their foreign counterparts, having developed their own individual survival strategies in various business settings. The Council and Forum together offer influential support for and input to the legal reform process.

The judiciary also constitutes a Supporting Institution for Company Law in Kazakhstan through its role in interpreting the law through decision-making. The new JSC Law – and to a lesser extent the LLC Law - establish strong standards of corporate governance and protection of shareholder rights. For example, Article 14 of the JSC Law gives shareholders the right to contest company decisions and board of directors resolutions in court and to seek relief from cognizant state agencies. These provisions are designed to curb self-dealing and other abuses of corporate governance.

It is still far too early to say whether the courts will intervene in a creative way in cases of this kind to rule against some of the more egregious machinations found in the corporate governance area. Some critics are skeptical that the courts will be able to play this role and that judges will understand the complex legal issues under consideration. Others see the courts, which already take an interventionist role in many other legal areas, as a positive force for strengthening corporate law.

Some of the persons interviewed by the team studiously avoided the courts and favored local arbitration and mediation, both of which become supporting institutions. Others were generally pleased with their judicial treatment. One respondent reported that frequent use of the courts for contract, labor and debt collection cases resulted in overall satisfaction with the quality of justice dispensed. In addition to general competence in decision making, the courts are reported to be much more efficient than those in other former Soviet Union (FSU) countries: cases are decided expeditiously (often within 30 days of filing the complaint), with adequate appellate recourse to the Supreme Court, permitting redress for unjust results in the lower courts.

Supporting Institutions, in summary, are still nascent but growing. The Council and Forum are expected to develop their roles increasingly over time, and while the courts seem well positioned to fulfill their supporting role. Other institutions are still needed – lawyers' associations, among others. Kazakhstan's scores on the Development Indicators reflect these developments.

The “Market” for Company Law Reform

There is no doubt that the Market for Company Law reform has greatly improved in recent years. Demand has grown from several directions. As noted above, the Foreign Investment Council brings foreign investors together with government representatives, creating an institutionalized channel for investors to voice their needs for law better attuned to the realities of market economics. Likewise, the Forum of Entrepreneurs of Kazakhstan serves a similar function for domestic investors. Together, the two groups represent an important source of demand for ongoing change in the legal framework of corporations.

Not all Kazakhstani business people are demanding reform. Many are quite content with the status quo, having adapted sufficiently through their own survival mechanisms. With changes being compelled by other sectors of the reform market, however, the status quo will change, inevitably affecting the nature of their own demands. The new laws have sparked a vigorous discussion in corporate boardrooms and among shareholders which may lead to intra-company reform, and this reform may well augment the demand for the new systems currently being instituted.

Lawmakers are regularly improving the supply of laws in the Company Law market. A few years ago there was practically a total absence of protection in the corporate governance area – namely the duties and responsibilities of directors and the protections and rights afforded to shareholders. Now legal standards exist and the issue has shifted to whether these rights may be effectively enforced in court.

In addition to the Company Law legislation described above, new laws on the securities markets and the registration of securities transactions were enacted in 1997. Securities are not fully defined under the law; therefore the decision whether a given instrument will be deemed a security rests with the National Securities Commission. Better definition is likely to develop with practice, possibly through regulations, as the Commission exercises its functions. The supply of laws in this area has improved greatly in recent years, and gaps such as the definition of securities can be expected to close over time.

In terms of the responsibility and predictability of the legislative process, Kazakhstan can do much to improve the situation. The business community still feels largely cut off from the legislative process. There is no established system for vetting draft legislation with business groups nor a generalized feeling that the business community has a meaningful role to play in shaping policy reform in the Company Law area. Now that a beginning has been made, Kazakhstan could do more to make its laws accessible, transparent, and user-friendly.

D. Competition Law

Legal Framework

The major enabling legislation in the regulation of competition includes the Anti-Monopoly Activities;¹⁴ the Law on Natural Monopolies;¹⁵ and the Law on Unfair Competition.¹⁶ These three laws establish an effective foundation for restricting monopolies and reducing anti-competitive practices. The common goals of these mutually dependent laws are to stimulate free competition, encourage entrepreneurship, insure consumer protection, and designate natural monopoly markets and their respective operating rules.

The principal implementing institution for the initial legislation was originally the Anti-Monopoly Committee, now known as the Agency on the Regulation of Natural Monopolies and the Protection of Competition (Competition Agency).¹⁷ It is a stand alone agency, not part of any ministry.

Kazakhstan, like other former Soviet republics, inherited a highly concentrated industrial structure with a completely monopolized distribution sector. Kazakhstan had no experience in promoting competitive practices prior to 1991. Existing state structures typically were in charge of setting socially acceptable prices with a sub-goal of preventing speculative transactions.

Kazakhstan has made significant progress in both developing antimonopoly legislation and implementing these laws. The country's legislation, developed with substantial international assistance, provides the basis for vigorous enforcement of sound competitive principles.

The following summarizes the principal legislation. Shortcomings in these laws are discussed after this overview.

1. The Anti-Monopoly Law (AML)

This foundation law is modeled on the competition laws of several Western countries. Its broad goals are to support free-enterprise ("entrepreneurship"), promote market competition, and prevent restrictive trade practices and unfair competition. This legislation is clearly drafted and provides broad but not detailed coverage of basic anti-trust concepts. The AML establishes an administrative body with regulatory authority that includes investigation and enforcement of anti-competitive actions. The Competition Agency is empowered to impose fines, confiscate property, and to initiate court proceedings to enforce its proposed sanctions. This regulatory body appears to combine many of the functions found in both the U.S. Federal Trade Commission (FTC) and the Anti-Trust Division of the U.S. Department of Justice.

¹⁴ *Law of the Republic of Kazakhstan Concerning Development of Competition and Restriction of Monopoly Activities* of June 11, 1991.

¹⁵ *Law of the Republic of Kazakhstan on Natural Monopolies* of July 9, 1998.

¹⁶ *Law of the Republic of Kazakhstan on Unfair Competition* of June 9, 1998.

¹⁷ The Competition Agency was formally known as the State Committee of the Republic of Kazakhstan on Pricing and Anti-Monopoly.

2. Law on Natural Monopolies (LONM)

The legislation was enacted to free "natural monopolies" from restraints and sanctions established in the foundation statute, the AML. The LONM defines natural monopolies as the "state of a commodity, works and service market, where the creation of competitive conditions for satisfying demand for a particular type of [service] is impossible or economically inexpedient due to the technical peculiarities of producing and providing of this type of services..." (Article 3(3).) The LONM establishes a list of applicable activities that are covered by the statutory definition, e.g., transmission/distribution of electric power. The legislation does not discriminate between private and public enterprises in these spheres of activities of natural monopoly entities (Article 4). The legislation includes enabling language for the authority and operation of a natural monopoly regulatory body as well as sanctions for violating the LONM.

Consumer protection principles are more thoroughly dealt with in the LONM than in the original AML. Sections appear on consumer rights (Article 11) and delivery standards for suppliers. This part of the LONM is followed by a section that establishes the buyer's (consumer's) obligation to pay for services rendered by the natural monopoly. (Electric utility payment receipt problems are believed to be the genesis of this language.)

3. The Law on Unfair Competition (LUC)

The LUC moves beyond the general language found in the AML foundation legislation by providing a serious statutory basis for dealing with unfair competition. Specific coverage encompasses:

- a) definitions of actions considered as unfair competition;
- b) mechanisms for preventing and eliminating unfair competition; and,
- c) liabilities associated with anti-competitive behavior including specific sanctions.

The LUC prohibits government agencies and self-regulatory bodies from enacting any regulations that would be discriminatory and therefore favorable to a particular party. Prohibitions include violation of trademarks, service marks, trade names, creation of appearances that will make it difficult to differentiate products, releasing misinformation for competitive gain, predatory contractual terms used in quasi-monopoly situations, collusion between competitors, predatory pricing, misappropriation of trade secrets, etc. It does not, however, handle institutional conflicts of interest with sufficient specificity, nor does it prevent the government from delegating the regulation of their private competitors to state-owned commercial enterprises, as with Kazakhtelecom and Kazakhoil.

Principal shortcomings with the above legislation includes the following:

1. The AML contains an automatic presumption that there is no monopoly so long as the enterprise in question does not control more than 35 percent of any one market. On the one hand, this presumption is not necessarily appropriate in the service and manufacturing industries, where less than 35 percent control may still lead to a non-competitive business environment that discourages new entrepreneurs. On the other

hand, experience in other countries suggests that a lower percentage might create unnecessary interference by the Competition Agency in vetting routine business transactions. The Competition Agency, as the principal regulatory and investigative body, needs to be authorized to establish regulations and guidelines that can effectively deal with different industrial sectors and dynamic economic conditions. While price controls may be imposed by the Competition Agency to companies with 35-65 percent market share, this does not necessarily rectify the dominance that already exists. Changes may, therefore, be needed.

2. The Competition Agency is not politically independent. The need for independence in investigations and administrative proceedings against violators is important in terms of assuring objective and transparent enforcement.
3. Sanctions are set by the enabling legislation rather than the regulatory body. This has direct impact on the effectiveness of both the law and the enforcing agency, the Competition Agency. For example, under the AML, fines are *de minimus*. Moreover, fines and other sanctions may be difficult to enforce through the courts, which are still relatively weak at this stage in their development.
4. The existing legislation does not require the collection, analysis, and free dissemination of anti-competition information. Current quantitative information is not easily accessible.
5. The AML and the subsequent supporting legislation is national in scope but it does not impose sanctions on local *Oblast* officials who participate in discriminatory actions that have an anti-competitive impact.

Implementing institutions

The Competition Agency of Kazakhstan is the principal government agency empowered to enforce the anti-competition laws. The President appoints the head of the Competition Agency, and the Competition Agency has a direct reporting relationship to the Cabinet. The Head of the Competition Agency is a member of the government. The Competition Agency performs functions similar to the U.S. Federal Trade Commission (FTC), the Antitrust Division of the U.S. Department of Justice (DOJ) and other federal regulatory commissions in the U.S. It was created under the AML.

The Competition Agency has seen its role expand due to subsequent legislative initiatives and Presidential decrees. For example, it has expanded its responsibilities to take over the role of the Pricing Committee originally found in the Ministry of Economy. The Competition Agency's principal functions now are de-monopolization, pricing and natural monopoly regulation, registration approval, market supervision and monitoring, investigations, prosecution, and consumer protection.

Since its formation in 1991 and as a result of USAID and other donor agency assistance, the Competition Agency has made dramatic progress in:

- expanding its staff's capabilities;
- assisting in developing a competitive private sector;
- building support for freer markets at both the Cabinet of Ministers and the legal community level; and
- reducing national government regulation of the market; and improving its own regulation of natural monopolies.

These achievements have come about because of major support at the highest levels of government. President Nazarbayev's commitment to a market economy continues with a vision of an economy dominated by the private sector and a shrinking government that intervenes less and less. This is illustrated in part by the Presidential Decree on Insurance, signed on October 3, 1995, which undid the protectionist provisions of the 1992 law (prohibiting foreign participation in local insurance) and re-opened the insurance market to foreign investors.

The Competition Agency suffers, however, from a number of problems that are common to many other government agencies. These include: a high turnover of staff; inability to get qualified staff; inadequate operating and training facilities; limited allocation of budgetary resources; local, *oblast* cooperation problems; and dependence for enforcement on a court system that often lacks the training to appreciate the legislative intent and applicability.

The LUC allows the Competition Agency to counter anti-competitive actions taken by individual state agencies or government officials. Prospectively, this may enable the Competition Agency to prohibit anti-competitive actions taken at the local level and directed at foreign investors. These actions range from the never-ending barrage of local decrees and unique legislative interpretations and enforcement standards that are used as the basis for taking action against foreign investors and local entrepreneurs. One recurring example is the high incidence of frequent tax inspections. These are costly and time consuming, and are occasionally used to undermine the competitive position of the targeted enterprise. The LUC may be used to empower the Competition Agency to address discriminatory practices in the Government of Kazakhstan procurement process that permit domestic suppliers to exceed foreign quotas by up to 20 percent. Whether the Competition Agency will be able to enforce such provisions effectively against the government remains to be seen.

Supporting Institutions

As is the case in Ukraine, it is difficult to assess the role of supporting institutions in the enforcement of the antimonopoly legislation in Kazakhstan. There are questions about the reliability and completeness of the data available from the courts with respect to anti-monopoly cases.

Aside from the courts, various other agencies have come into existence that complement the Competition Agency by promoting an anti-monopoly environment. For example, the Agency for the Support of Small Businesses, established by Presidential Decree in 1998, is intended to promote small business development, analyze small enterprises' competitive position, and interface with agencies such as the Competition Agency to assure a "level" playing field. Its level of activity and effectiveness is difficult to judge at this time. Another example is the Gosstrakhnadzor, created under Articles 40-52 of the new reinsurance law. This statute creates a

supervisory insurance body that has as its genesis the First Presidential Decree on Insurance No. 1658 (April 16, 1994). It is a regulatory body with investigative powers intended to help end a monopoly position for certain types of investment reinsurance.

Unfortunately, there are no data about any meaningful cooperation between the Gosstrakhnadzor and the Competition Agency nor is there any reliable data on the effectiveness of the former institution with respect to improving the competitive environment. Finally, there do not appear to be any NGOs that have become effective adjuncts to the Competition Agency.

In summary, several supporting institutions have been created for the purpose of engendering greater competition. The data currently available, however, do not permit an assessment of their effectiveness.

The "Market" for Competition Law Reform

Kazakhstan's Competition Agency has been effective both as a regulatory body and as a catalyst for changing the government's pro-monopoly orientation that carried over from the Soviet period. It has greatly increased demand for reform by sensitizing both government officials and the business community to the advantages of a free-market economy with healthy competition. The Competition Agency has achieved these results through a variety of training programs and education programs at both the state and *oblast* level.

Advocacy for change in this area is also driven by the domestic private sectors, the foreign investor, and international treaties. While U.S.-style lobbying continues to be frowned upon, groups such as local chambers of commerce and the American Chamber of Commerce, nevertheless, make anti-competitive legislation and enforcement a principal topic of discussion at their regular meetings. They are somewhat effective in communicating their concerns to both Parliamentarians and the President. The President, in fact, appears to consider anti-monopoly enforcement one of the cornerstones of his current economic development regime as is evidenced by both recent decrees and his recently convened foreign investor advisory board. Finally, it is noted that some court cases have resulted in favorable, pro-competition judgements for foreign plaintiffs.

Local government interference with the private sector, especially foreign investors, continues to be a major problem in Kazakhstan. This behavior is often seen as motivated by local officials wanting to offer competitive advantages to favored (local) enterprises. This problem has been a major catalyst for local entrepreneurs and foreign investors calling for enforcement of the anti-monopoly laws and regulation of local government officials who frequently take actions that counter existing legislation. Because it is evident that some of the *oblast*-level interference with private sector enterprise is a direct result of poor training, local government revenue shortfalls, low wage rates, corruption or a combination of all of the preceding, foreign donors are encouraging the Government of Kazakhstan to take corrective measures. In keeping with this, the Competition Agency has undertaken a number of training programs at the local level to overcome anti-competitive actions.

In summary, demand for competition law reform and enforcement is noted among both the domestic and the foreign investor. Budding local entrepreneurs in sectors such as insurance,

banking, and food distribution are keenly aware of the potential and actual negative impact on their businesses of anti-competitive practices. They remain sanguine, nevertheless, about an improving environment. Our investigation found several instances of Kazakhstan citizens who, after living abroad, returned to the country to become investor-entrepreneurs because the "free-enterprise" climate has improved.

E. Contract Law

Legal Framework

The Constitution of Kazakhstan recognizes the equality between public and private property and the protection of private property rights (Article 6 – 1). Although it reserves certain assets or objects for ownership by the state, even those can be included in contractual obligations to which the state is a party. The Constitution also specifies that restrictions on private property may be imposed in order to protect public interest. Separate laws may specify any such restriction. Land is owned by the state, but can also be held as private property under the terms and conditions specified in the law.

The Constitution does not provide directly for freedom of contracts, but has a general guarantee for entrepreneurial freedom (Article 26, (4)) which implies freedom of contract as well.¹⁸ However, freedom of contract is guaranteed explicitly by Article 14 of the Civil Code as one of the basic rights of Kazakhstani citizens.

Kazakhstan's contract law is contained in the Civil Code, but the Second (Special) part of the Code had not yet been adopted during the assessment (however, it was subsequently on July 1, 1999. As a result, the framework law for contracts was not yet fully in place at the time of the assessment. Parliament previously rejected the bill containing the Second (Special) part of the Civil Code because of several contradictions to the Constitution. The rejected draft was based on the Model Civil Code, prepared for the CIS countries, and adopted with some changes in Russia and several other republics. The General part of the Civil Code in Kazakhstan is based on the same model. There were no policy arguments over the Code, but in the opinion of the Constitutional Council the draft needed to be brought in line with the Constitution. Evidently, these needs were met by version adopted by the Parliament in July.

The basic contract law of Kazakhstan is the Civil Code of 1995.¹⁹ The Code contains 405 Articles and covers all basic transactions and the formal requirements for their validity. The Kazakhstani law provides for some separation of business and non-business transactions. This separation is based on the nature of the legal entities or the activities of the individuals involved. Individuals and family units may act as entrepreneurs, in which case different rules or standards of care may apply to some transactions. Legal entities are classified as either commercial or non-profit organizations, and each classification has tax²⁰ and other consequences.

The law does not recognize any formal difference between commercial and non-commercial contracts. Developing legal theory, however, has begun to delineate the most the most important features of business relationship, such as:

¹⁸ The text, at least in the Russian translation, states that “every legal entrepreneurial activity is permitted” instead of the common principle, that “every activity, not specifically prohibited by the law, is permitted.” As a result, different interpretations of what is legal may be offered. Such wording gives rise to the arguments restricting activities not expressly permitted by law.

¹⁹ Adopted on December 27, 1994, in force as of March 1, 1995.

²⁰ In practice, however, all organizations are currently treated the same for tax purposes.

- the nature of parties (legal entities or individuals, registered with the State and involved in business activities);
- the special business relations, regulated by the contract (primarily property-related activities, except property transfers related to consumer transactions between individuals);
- any special form, required for the conclusion of contracts;
- any special liability of the parties, including product liability.

The law in Kazakhstan requires the registration of all business entities and most individuals involved in commercial activity. (See Civil Code Art. 19.4 for individuals and Art. 42 for legal entities.) Individuals and businesses cannot, however, use the lack of such registration as a defense in cases when they have been parties to business contracts.

The legal framework for contracts has no significant gaps or weaknesses, at least theoretically. Problems exist at implementation level and are related primarily to the capacity of the judiciary to handle complex commercial cases. Commercial arbitration in Kazakhstan is in nascent stage, but there are no legal obstacles for the parties to commercial contracts to agree on arbitration clauses in their contracts

Implementing Institutions

Dispute resolution on contractual matters in Kazakhstan is carried by the Economic Sections (Collegia) of the district and regional courts. In 1998, they handled approximately 18,000 new cases, a reduction of about 10% from 1997. Almost two-thirds of the cases (65%) are generally resolved within one year and within the time limits established by the law.

Kazakhstan's court system functions reasonably well compared with other countries in transition. The Supreme Court regularly publishes case summaries, including a special section on economic disputes. Lower courts do not yet publish summaries, and there is no classified summary available separating cases according to Code Section or type of dispute. The courts could benefit strongly from improved judicial training, better administrative practices and better dissemination of information. For three years, these issues had been addressed by USAID projects; recently activities in this area have been transferred to the World Bank who has begun implementing a Judicial Reform Project.

Supporting Institutions

Notary services are one the most important supporting institutions for contract law. Notaries have a special role in the continental legal tradition. In Europe, notaries have historically been attorneys who had the privilege to record transactions. Often the notary prepared the documents for the transaction. The books, kept by the notary, served as important evidence of the time and place where transactions were concluded and of the parties involved. In some jurisdictions the institution developed as a parallel land recordation office. The role of the notary has grown beyond simple recordation of facts.

For a European-trained lawyer, the idea that a person without legal training can be a notary will sound outrageous. Yet most of the European laws allow some notary certification services to be provided by non-lawyers in certain circumstances, when access to attorneys is limited or impossible (e.g., on board ships, in remote areas of the country or in military units).

For the purposes of complex commercial transactions the role of the notary becomes more important, yet more limited in scope. On one hand, it is essential to formalize and establish the time of many transactions. On the other hand, those transactions require more complex legal documentation and the notaries cannot be expected to be experts in all areas of law. Yet the law often requires that the notaries review the documents not only to ensure compliance with formalities, but also with respect to their legal content. The state thus attempts to ensure legal stability by guaranteeing that all notarized documents are prepared in accordance with the law.

The situation in Kazakhstan is similar. The Kazakhstan law on notaries generally follows the European legal tradition in maintaining most of the obligations of the notaries beyond simple certification. Notaries in Kazakhstan may only be only Kazakhstani nationals with legal training and at least two years of experience. They must be properly licensed after passing special examinations. Licenses have no time limit and are valid for the entire territory of Kazakhstan. However, certain activities can only be performed by notaries within a specified notary district (i.e. where the real estate is located), and only by notaries admitted to practice in that district.

Private notary practice is allowed and private notaries have the same rights as state notaries. Notary licenses can be suspended or terminated in certain cases, strictly specified by the law (including medical reasons, which prevent the notary from carrying out his obligations, commission of a crime by the notary, gross violations of the requirements for document certification and other similar violations). The decision to suspend or terminate a notary license is subject to appeal.

Allowing private notary practices is a major feature of the new Kazakhstani system. This will improve the accessibility of notaries, increase competition and reduce transaction time. It will also allow certain specialization of the notaries in recording more complex transactions.

Yet the new law does not address some of the principle problems of the European system. It still requires the notaries to review all documents for legal content and inform the parties as to the legal consequences of execution of particular documents. While this provision has some justification in the case of non-complex, day-to-day transactions between individuals, it is unnecessary and even troublesome in complex commercial transactions between sophisticated parties. This situation permits notaries to insist on contract modifications that may not represent the interests of the parties and that may result in unreasonable delays. It may also result in varying practices in different parts of the country or in different notary offices. These legal reviews do not reduce the need for commercial attorneys in the preparation of complex transactions, but can increase the cost of counsel as the lawyers must negotiate with the notaries and renegotiate with each other based on the notary's proposed amendments.

The notaries are restricted by law from participating in any other entrepreneurial activity and from providing legal services other than those related to their notary practices. These

requirements reduce the likelihood of notaries pushing for any reduction or simplification of notary practices that would affect their income levels.

The Ministry of Justice establishes fees for state notary services. Private notaries can negotiate their own fees with the parties. In many cases notary fees are also based on the value of the transaction rather than the level of effort of the notary. Most of the fee in such cases is directly transmitted to the state budget and in fact serves as a stamp duty unrelated to the service provided by the notary. For instance, to notarize a loan agreement for \$1,000,000 or \$100,000 will require basically the same amount of work, yet command different fees, representing a percentage of the value of the transaction.

Notaries have several other important functions, related primarily to commercial transactions. They may serve as escrow agents and receive payment from debtors for transfer to the creditor, may certify documents for execution based on judicial decisions or other execution titles, as provided by the procedural laws. They may also accept documents for safekeeping.

Prior to the commencement of court action and upon request by the parties, notaries may take action for preliminary injunction in cases when there is serious danger that documents or other evidence may be destroyed. They may also depose witnesses and assist the parties in collection of other evidence.

Kazakhstan has made significant progress in improving the notary practices. The problems in the system are related mostly to the traditional approach to the functions of the notaries. Such fundamental changes are highly unlikely.

The "Market" for Contract Law reform

There is currently little demand for ongoing reform of contract law because the legal framework is virtually complete, and the "consumers" find it generally satisfactory, especially with the adoption of the Second (Special) Part of the Civil Code. As Contract Law is tested over time in the courts, additional need for reform may arise based on practical experience. For now, however, there is no significant recognized need for change.

Although the Civil Code seems to be addressing adequately the demand for Contract Law at this time, there does seem to be some confusion over the position of the Civil Code itself in the hierarchy of laws in Kazakhstan. In general, laws and codes are on the same level, so that in the event of a conflict, the most recently adopted prevails. Legal construction might be better served, however, if the Law on Normative Acts, which defines the hierarchy²¹, were amended to

²¹ The Law on Normative Acts of November 1998, ranks the laws in the following order of importance:
Constitution
Laws changing or adding to the Constitution
Constitutional Laws and Decrees of the President having the force of constitutional laws
Codes, laws and Decrees of the President having the force of law
Normative Decrees of the President
Normative Acts of Parliament
Normative Acts of Government
Normative Orders of Ministries and State Committees
Normative Decisions of Mayors

raise the status of the Civil Code so its provisions could be altered only by amendment, and not by subsequently enacted laws outside of the codes.

Recent improvements in the supply of contract law are due in part to substantial foreign assistance. Several international projects have supported the development of new legislation. The government has carried out several annual legislative programs, with assistance from international experts, resulting in systematic development of legislation. These programs helped to overcome instability in the first few years after independence resulting from frequent legislative changes.

The more important market for reform at present is for the implementing institutions. Demand exists from the commercial community and the judiciary for judicial training, improved legal education, administrative reforms of the court, and better dissemination of information. Such reform is already being supplied through the Judicial Reform Project. Time will tell how much additional work will be needed.

There is little recognizable demand for reform of the supporting institution of notaries. A more efficient system of pricing, as well as removal of employment restrictions for notaries could permit rationalization of fees and services. Such demand would have to come from the users, but has not yet surfaced in any significant amount. Currently, the supply of notaries in terms of availability and cost is considered sufficient.

F. Foreign Direct Investment (FDI) Law

Kazakhstan is very serious about attracting foreign investment, and this is reflected in the indicator scores. To date Kazakhstan has attracted over \$6 billion in FDI, with \$1.2 billion in 1998. The expected inflow for 1999 is over \$1 billion, but will be lower than in 1998. On a per capita basis Kazakhstan ranks well above all of its neighbors, but is behind the best performing transitional economies in Central and Eastern Europe and Estonia. Yet, foreign investment has largely remained limited to the energy and oil sectors and the related service industries, with little or no effect on the rest of the economy. Being of primary importance for the country, the oil sector is regulated by separate law, but the foreign investment legislation is also applicable in certain circumstances.

Framework law

Kazakhstan has a liberal foreign investment law²², which places few restrictions on foreign investment, and conforms to what are accepted as international standards for admission and treatment of foreign investors. The law establishes the following general principles:

- National treatment of foreign investors, except in a limited number of cases related to the national security;
- General guarantees against substantive changes in the legislation that will diminish the position of the foreign investor (which permits the investors to be grandfathered under the most favorable provisions of any abolished legislation for up to 10 years);
- Full and adequate compensation based on the market value of the investment in case of nationalization or expropriation;
- Guarantees against arbitrary expropriation;
- Guarantees of repatriation of all profits and other investment related income;
- Duty-free import of the production assets of enterprises with foreign participation;
- No restriction on the employment of foreign staff and managers²³; and
- Flexible dispute resolution procedures, including arbitration between the state and the foreign investor in internationally recognized venues.

In general, Kazakhstan has stood by these guarantees, but there have been difficulties reported in repatriating profits in at least one case involving a terminated joint venture. Consistent implementation will be essential to ensure investor confidence.

The registration procedures for companies with foreign participation are similar to those for local companies and do not place a significant burden on potential investors. The law makes an attempt to limit any unnecessary involvement in the business activities of foreign enterprises and to protect them from the rent-seeking behavior of various local and central government

²² *Law on Foreign Investment of December 27, 1994, N 266-XIII*, as amended. (Most recent amendment was April 22 1998, N 221-I.

²³ Since completion of this assessment, Kazakhstan has imposed non-transparent, extensive work permit requirements on all foreign employees, replacing the less intrusive regime encountered during the assessment.

institutions. This provision is more a policy statement than directly applicable norm, but it is important indication of the intentions of the government.

The framework law is on par with the good examples of similar legislation in other transition economies and with the standards set up under model international legislation. It also shares the weaknesses of similar laws elsewhere: it contains too many policy provisions and too few directly applicable norms, while referring frequently to other, unspecified laws.

Another problem is more serious, undermining confidence in the legal investment climate. Existing foreign investment laws could be improved, but are generally accepted by and acceptable to investors. Even so, they have been frequently altered and amended, with six changes during its first five years (three in 1997 alone). Although the amendments do not affect the general principles of the law, they create an impression of legal instability.

Other laws of direct importance for foreign investors are the Law for State Support of Investment Activities and the Law on Free Trade Zones.

Kazakhstan also provides a number of additional investment incentives not included in the main framework law. Those are granted to investors in priority sectors of the economy, in industrial infrastructure or in the new capital Astana pursuant to special agreements concluded between the investors and the Agency for Investment. The incentives include:

- Tax holidays of up to five years, with possible reduction of 50% of the profit tax for another five years;
- Natural grants from the state (i.e. contribution of land, buildings or other facilities to the enterprise); and
- Release from customs duties for the import of goods necessary for the implementation of investment projects. (This provision seems to replicate the provision of Article 22 of the Law on Foreign Investment, which provides very broad exemption from customs duties.)

For some investments, additional security is available by treaty. The European Energy Charter Treaty provides additional protection for investments in the energy sector. Kazakhstan was one of the original signatories to the Charter, and under its terms guarantees that treatment of foreign investment in energy will not be altered while Kazakhstan remains a party to the Charter. This lowers the risk of arbitrary or unexpected changes in the investment framework. Moreover, the Charter elevates some breaches of contracts by governments with private firms violations of the treaty itself. This further lowers the risk of arbitrary or capricious changes. Although the Charter provides no special incentives, it does increase stability for investments in the energy sphere. For European investors, there is another stabilizing influence -- the Partnership and Co-operation Agreement. This treaty provides additional protection for investors from the EU.

Implementing institutions

Kazakhstan has two implementing institutions with clearly defined functions: The Agency of the Republic of Kazakhstan on Investment (ARKI) and the Kazakhstan Investment Promotion Center (Kazinvest).

ARKI was initially established as the State Investment Committee (SIC) under the Law on State Support for Investment. As of June 1, 1999 SIC was restructured as ARKI. It is located in Astana and has the following basic responsibilities:

- Development and implementation of the investment strategy of Kazakhstan;
- Development of proposals and implementation of measures to improve the investment climate;
- Promotion of investment opportunities in Kazakhstan; and
- Protection of the rights of foreign investors.

The main functions of the Agency include the following:

- Maintenance of statistics on foreign investment in Kazakhstan;
- Preparation of legislative amendments related to foreign investment;
- Preparation and negotiation of international agreements related to foreign investment, including bilateral and multilateral investment treaties and conventions;
- Identification of the priority sectors of the economy that qualify for direct state support;
- Identification, together with other authorized state agencies, of the sites of concessions for exploitation of natural resources;
- Registration of all licenses granted with relation to investment projects; and
- Monitoring of the implementation of investment projects and fulfillment of the contractual obligations of the parties.

The Kazinvest is responsible for general promotion of Kazakhstan as an investment destination and for the preparation and presentation of particular investment projects. So far, Kazinvest has prepared a database of over 700 investment projects and organized a number of seminars.

In contrast to ARKI, Kazinvest was conceived as a more business-oriented institution, participating directly in project implementation. Overall evaluation is still premature due to their short tenures, but ARKI and Kazinvest are both showing encouraging signs for success, including:

- Both have undertaken serious studies of experiences in other transition economies, and are adopting solutions based on these investigations and policy dialogues;²⁴
- Both institutions have clear mandates and are designed as investment-friendly, one-stop agencies;
- There is cooperation between private sector and government agencies (see the discussion of the supporting institutions below);
- There is a special set of incentives, including a salary scale different from that generally applicable for civil servants, for the staff of ARKI and Kazinvest, which reflects the desire of the Government to maintain high quality staff in those agencies.

²⁴ Some of the solutions have been controversial, such as an overcomplicated incentive system, which favors major projects over small and medium enterprises, but the institutions are expected to examine the results and make necessary adjustments in the future.

Even so, it is not clear that the Government of Kazakhstan views ARKI as a success in encouraging investment. ARKI, now under the Ministry of Foreign Affairs, has been scaled back, including a proposed amendment to the Foreign Investment Law and the Law on State Support to Direct Investment that would restrict ARKI's ability to offer tax incentives or relief for investment in primary economic sectors.

Supporting Institutions

Several institutions, similar to those in other countries, are active in Kazakhstan, including the American Chamber of Commerce, all of the major accounting firms and several established law firms, with international reputations. In terms of the available professional services there seems to be sufficient support, especially for major investors. There is still a lack of specialized consulting services for medium and small local companies, which need assistance in attracting international partners. The capacity for project preparation at this level is still limited.

The most interesting supporting institution in Kazakhstan is the Council of Foreign Investors. Although similar councils exist in other countries, the Kazakhstani Council is a model for cooperation between the public and private sectors. The Council consists of representatives of foreign companies active in Kazakhstan and of Kazakhstani officials. It meets with the President of Kazakhstan at least twice a year. At those meetings the Council presents a proposal for the work in the following 6 months and reports on the status of previously approved tasks.

The Council is not a damage-control institution, as is common in some countries, but rather a forward-looking body of experts who prepare proposals for the improvement of the investment climate in the country. Members of the Council interviewed for this diagnostic were very positive about the response of the authorities to their proposals and the fact that Kazakhstani officials participate in the work of the Council.

Market for reform

The market for reform of foreign investment laws poignantly exposes the conflicts between "East" and "West," and suggests that they have yet to meet completely.

The primary source of demand for foreign investment reform comes, quite naturally, from the foreign investors themselves. With the Council of Foreign Investors, they have an excellent institutional platform for voicing their needs and wishes. Complementing this is a cadre of government officials who recognize the importance of foreign investment and generally understand what is required to attract foreign capital. Thus the government itself—under the vigorous leadership of the President—is demanding change.

In a parallel move, there is a growing demand for reform among actual and potential domestic investors. They have recognized the disparity between incentives for large foreign projects and those for small and medium domestic investments, and are crying out for their own benefits. This could lead easily in two directions. First, it could improve the overall investment climate by causing the government to recognize the need for all investment, not just large, foreign projects. By promoting investment generally, without foreign/domestic discrimination, the environment

and economy will improve. The Forum of Entrepreneurs represents a potential source of demand for such changes.

On the other hand, a number of regions have exhibited substantial misunderstanding over the need for foreign investment. There are numerous complaints from the investment community that foreign investors are not treated well by the local authorities, despite the efforts of the Government to improve the situation. Reasons for this ill treatment, other than the corruption and extortion problems identified as the main obstacles to investment by most foreign investors, focus on inadequate understanding by the local authorities about the need for foreign investment for the country. There appears to be little effort at this time to promote investment opportunities at the regional level. Without improved understanding, some regions may oppose future reforms while restraining current ones.

In light of the dialogue with the investment community through the Council of Foreign Investors, there is likely to be an ongoing supply of reform initiatives. The Council has the resources and motivation—while neither is a continuous guarantee—to supply policy, legal, and regulatory ideas for additional reform efforts. These efforts, however, are likely to be diluted or blocked at the regional level unless someone also supplies the necessary promotional activities to begin changing attitudes.

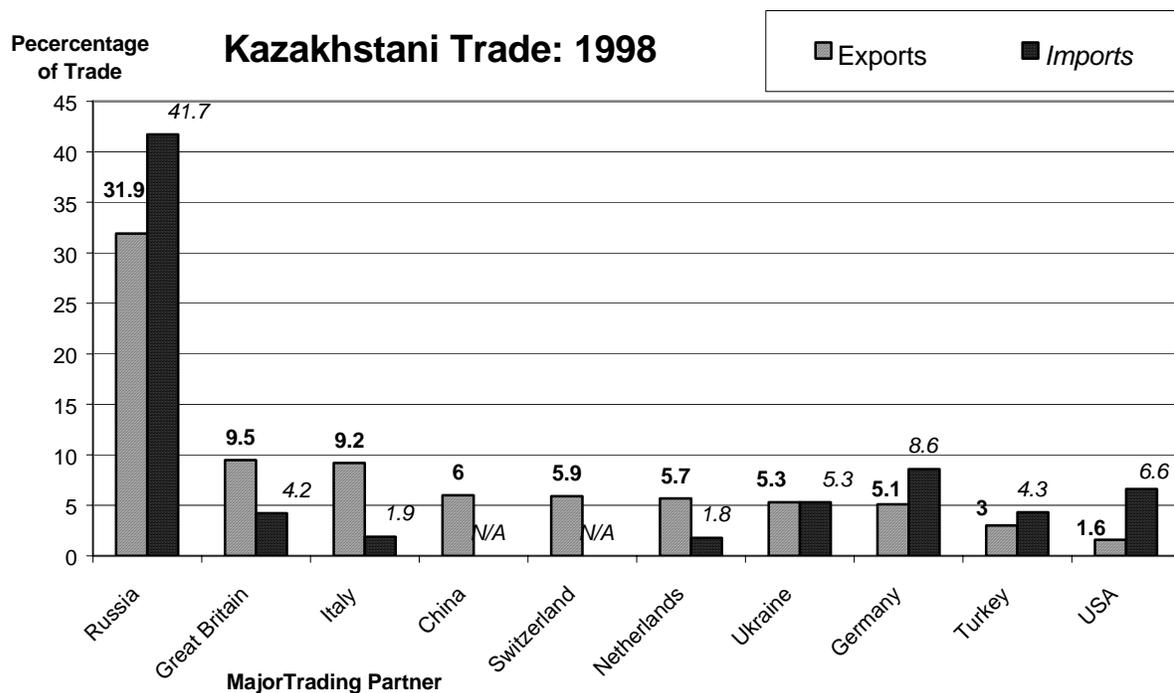
There is also a weakness in the supply of some of the activities necessary to support or reform and increased investment. First, although the implementing agencies have studied the experience of other countries, they have little experience of their own, and little capacity to implement some of the best practices, particularly annual competitiveness reviews and reviews of the technical and administrative barriers to entry. No such reviews have yet been conducted, and thus an important element is missing for identifying further reform needs.

Second, project preparation skills are quite limited. Although this does not affect the legislative framework, it does lower the implementing capacity of the existing investment promotion institutions. For example, Kazinvest has identified more than 300 investment projects, but cannot perform proper presentations of these opportunities. Assistance can be provided in those areas and in the development of proposals for improvement of the investment climate. This situation limits the ability of the local sponsors to seek serious foreign investors and delays project implementation. The experience of various U.S. regional investment promotion authorities could be particularly useful at this stage in the development of Kazinvest and ARKI.

The market for legal reform thus presents a number of challenges to Kazakhstan. The Council, the Forum, Kazinvest, and ARKI together can have a tremendous impact on the shape of the investment climate, but they will somehow have to respond to and begin to reshape the less hospitable investment climate at the regional level.

G. Trade Law

The legal and institutional regimes governing international trade are broad-ranging and complex. By design, many aspects of trade regimes are responsive to changing economic and non-economic factors. Both the diagnostic indicators for trade and the following narrative summary provide a "snapshot" of current conditions without conducting a detailed analysis of the trends or nuances at play in the development of this important area of commercial law.



As summarized in the general indicator table at the beginning of this report, Kazakhstan has a population of 16.9 million and a GDP per capita of \$2,880. With its land mass stretching 3,000 miles from the Caspian to China and 1,500 miles from the northern steppes to the Central Asian heartland, Kazakhstan is the ninth largest country in the world. Its five land borders have historically made it a center point in East-West trade and serve, even today, as an indicator of Kazakhstan's potential to play a pivotal role in regional trade.

As the table above shows, Kazakhstan trades predominantly with the Russian Federation and only secondarily with the European Union (EU) and the U.S.²⁵ Kazakhstan is party to a customs union which includes Russia, Kyrgyzstan, and Belarus. Total trade turnover in 1998 was \$8.77 billion with a slight balance of trade surplus that, in turn, is assumed to have been compensated for through "suitcase trade" leaving a de facto current account deficit. A primary explanation for

²⁵ Source: ANYA – *Kazakhstan Annual Country Profile, 99/1 Anya Ltd.*; Almaty, 1999.

that deficit lies in the sharp fall in export revenue explained by low world minerals and oil prices and the contraction of NIS markets.²⁶

Legal Framework

Trade relations between Kazakhstan and the U.S. are governed by a Bilateral Investment Treaty that entered into force on February 18, 1993. The agreement provides for Most Favored Nation status for products of both countries. It significantly improves market access, and it provides non-discriminatory treatment for U.S. goods and services in Kazakhstan and for Kazakhstani products in the U.S. The agreement also obligates both states to protect intellectual property rights and reaffirms both countries' commitment to the protection of such rights. (In practice, however, such protection has been lax, at best.) Kazakhstan is a member of the Generalized System of Preferences (GSP) which provides preferential duty-free entry to over 4,000 products from designated beneficiary countries.

Kazakhstan has, since February 1996, held observer status in the World Trade Organization (WTO)/General Agreement on Tariffs and Trade (GATT). It is currently applying for full membership in that organization and has carried out significant reforms to prepare for accession. In October 1998 Kazakhstan participated in its third Working Party meeting in Geneva where its revised offer on goods and services evoked applause – but no agreement. Kazakhstan has since opted to conduct goods negotiations on a bilateral level with WTO member countries.

During the three years since its initial application to the WTO, the Government of Kazakhstan has produced several partial tariff schedules that have been submitted to the WTO Secretariat. It has cooperated fully with the Secretariat and with member countries, responding to formal questions arising out of Working Group meetings and bi-lateral negotiations. Pending areas of concern for negotiations include the problematic issue of financial services and the substantial issues related to foreign access to the banking and insurance, telecommunications, and transport sectors.

Kazakhstan's current tax and import duty regimes are defined, to a great extent, by the Agreement for the Avoidance of Double Taxation that was signed in 1993 (in conjunction with the Bilateral Investment Treaty) and ratified in late 1998. All Kazakhstani Tax Laws must be contained within the Tax Code of April 1995 (already amended in excess of 20 times), the current form of which imposes a Value Added Tax (VAT) of 20% to all goods and services imports. No VAT applies to exports except to other NIS countries where, by agreement, the "principle of origin" dictates that exports are fully taxed and imports are not taxed.

As of March 1999, 200% tariffs were levied on selected goods, mostly foodstuffs, beverages, and tobacco without expiry dates, from Russia, the Kyrgyz Republic, and Uzbekistan. This measure was in keeping with the defensive suspension of Russian-produced goods imports that was imposed in the wake of the Ruble devaluation of late 1998. Since the end of the June Assessment, these 200% tariffs have ended.

²⁶ *Commercial Overview of Kazakhstan, June 1999*. Business Information Service for the Newly Independent States. Chapter II – Economic Scenario.

Customs delays remain a concern of importers despite the 1998 amendment of existing rules. Measures intended to streamline the import entry process, including allowing the use of faxed invoices, have been implemented. However, the inefficient organizational structure of the State Customs Committee (SCC) remains an impediment to smooth customs processing.

According to the United States Trade Representative, Kazakhstan's persistent trade barriers include issues of contract sanctity, burdensome customs requirements, aggressive tax inspections, vague commercial law structures, inefficient registry administration, and intellectual property rights (IPR) failings. On IPR matters, the Kazakhstani government has adopted a Law on Copyrights and Neighboring rights, a Law on Trademarks, Service Marks and Appellations of Origin, and a Law on Patents. All these laws are largely in conformity with international IPR principles but it is noted that enforcement of such laws has been rare and arbitrary.

Implementing Institutions

For the purposes of this Assessment, Kazakhstan's implementing institution for trade is the Ministry of Energy, Industry, and Trade (MEIT). This is the principal government institution for generating state policy on international trade including proposals on customs rates subsequently implemented by the State Customs Committee; on attraction and allocation of foreign investment; and concerning settlement and credit relations in the context of international agreements. MEIT also issues import and export licenses. Consistent trade policy emerging from the Ministry seems indicative of a sound organizational capacity, and its prompt response to foreign queries, albeit supported by expatriate foreign trade consultants, demonstrates the effective commitment of the Kazakhstani government to trade policy enhancement.

Kazakhstan's adherence to the GOST regime of standards, administered by the Gosstandart agency of Kazakhstan, constitutes only a minor impediment to the entry of foreign products into the Kazakhstani market. The GOST (*Gosudarstvenyi Standart* or "State Standard") was established by the former Soviet Union, based originally on German standards of the 1930s. It has been updated on a piecemeal basis, leaving some differences between Kazakhstani standards and Western or international standards. These differences require re-certification of many imported products. In November 1996, the U.S. National Institute of Standards and Technology signed a Memorandum of Understanding with Gosstandart of Kazakhstan to bring Kazakhstani metrology methods into conformity with international rules and practices.

Supporting Institutions

The State Customs Committee (SCC), located in Astana, is the central customs body. It manages 13 customs departments, located in each oblast, and 16 customs houses, located throughout Kazakhstan, including four in Almaty oblast. It is responsible for a total of 12,012 kilometers of land borders and for ensuring that all imports are declared within 15 days of country entry. High government revenue through customs duties (\$12.9 billion tenge – 6% of government revenue) ensures that the SCC receives appropriate funding for enforcement and, in fact, at present proposals exist to reinvent the SCC as a separate ministry to the MEIT.

Despite healthy funding levels, SCC performance is unpredictable. Historically, long delays in processing imports through customs have impeded smooth trade relations (while resulting in

increased warehousing revenues for the SCC). Although customs valuation rules largely conform to the GATT Valuation Agreement, and despite Kazakhstan's having patterned its tariff nomenclature after the WTO's Harmonized System, long delays at customs processing departments mean the SCC receives a lower organizational effectiveness rating than Kazakhstani legal structures might have supported.

The "Market" for Trade Liberalization

The market for trade liberalization in Kazakhstan is relatively strong. The progress Kazakhstan has made in meeting the requirements of WTO membership is demonstrative of the government's commitment to a 30-year development program recently announced by President Nazarbayev as "Independence, Prosperity, and Political Stability in Kazakhstan by the Year 2030." On the demand side of the liberalization question, the most consistent advocates of reform have been foreign trading partners and their nationals doing business in Kazakhstan. The government has shown itself to be responsive to their concerns and to the possibility of WTO accession. Unfortunately, as of yet, real progress on a legal level has been only imperfectly translated into effective implementation on an institutional level. The "gravitational pull" of prospective WTO membership holds sway in Kazakhstan to a similar extent that it does in Romania though, without the overwhelming support of the European Union, Kazakhstan has obviously not adapted at Poland's pace. Overall, it appears that Kazakhstan's commitment to trade law reform, once it is fully enforced, has the potential for a measurable positive impact on the living standard of the Kazakhstani people.

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