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**TRADE AND INVESTMENT REFORM  
SUPPORT PROGRAM IN AZERBAIJAN**

# **DEVELOPING AZERBAIJAN'S CAPITAL MARKET: AN ASSESSMENT**

**Prepared for**

**The Azerbaijan State Committee for Securities and  
USAID, Azerbaijan**

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## **ABBREVIATIONS**

AZIPS - Azerbaijan Interbank Payment System  
BSE – Baku Stock Exchange  
CIS – Collective investment schemes  
GDP – Gross Domestic Product  
IAS – International Audit Standards  
IFRS – International Financial Reporting Standards  
IOSCO – International Organization of Securities Commissions  
NB – National Bank of Azerbaijan  
OJSC – Open Joint Stock Company  
RTGS – Real Time Gross Settlement System  
SCS – State Committee for Securities of the Republic of Azerbaijan  
SRO – Self-Regulatory Organization  
STP – Straight Through Processing

## **I. EXECUTIVE SUMMARY**

While considerable progress has been made in establishing a legal and regulatory environment and the institutional infrastructure to support development of a securities market in Azerbaijan, the market remains underdeveloped and slowly developing.

Notable constraints to market development include those associated with the market's organizational and operational infrastructure, corporate governance and the protection of investors' rights, and the supply of financial products in the marketplace. Priority constraints and recommendations by area of concern are discussed briefly below.

### **MARKET'S ORGANIZATIONAL AND OPERATIONAL INFRASTRUCTURE**

#### **Government Securities**

**Priority Constraint:** Commercial banks access to government securities is compartmentalized and requires the commercial banks to deal through licensed securities brokers.

**Recommendation:** Grant an exception (amend the Civil Code) to allow commercial banks to deal directly when executing government securities trades (including primary issuances, secondary market trades, repos, etc.) with other commercial banks or with the central bank without a broker or dealer involved in the transaction.

#### **Licensed Securities Depositories**

**Priority Constraint:** There are three licensed central securities depositories in Azerbaijan. Two of the central depositories handle only corporate securities. The third central depository, located inside the BSE, performs depository functions for all government securities and performs no depository functions for corporate securities.

**Recommendation:** Consolidate all three central depositories into one licensed central securities depository for government securities and corporate securities. This depository may be two-tiered, or feature remote locations with full electronic linkage back to the central location in Azerbaijan, but it is essential to reduce the number of corporate securities depositories to one, and it is currently useful to co-locate the government securities depository with the corporate securities depository.

#### **Central Lien Registry**

**Priority Constraint:** Currently Azerbaijan's central lien registry, a state organization, is located inside the State Committee for Securities. This central lien registry records liens against all types of securities. The central lien registry is responsible for attaching and registering a lien on the asset inside the registry where the asset is registered. Additionally, there is a lien registry within one of the departments of the SCS which records liens against

house certificates, mortgage certificates, guarantees, and collateral of other types which are non-securities.

- **Recommendation:** First, move the central lien registry outside of the State Committee for Securities and locate and integrate its activities with those of a consolidated central depository. Second, migrate all functions, business processes and records of the central securities lien registry to an electronic format. Third, seamlessly integrate the functions and business processes of the state central securities lien registry with respect to liens on securities into the business processes of a consolidated central securities depository, trading system and clearance & settlement system. Fourth, as soon as practicable, move all non-securities related lien registration activities outside of the SCS and to a more suitable locate such as the State Movable Property Registry which is currently under development.

### **Securities Clearance and Settlement Operations**

**Priority Constraint:** Processes involving clearance and settlement are designed around manual operations. These business processes need to be streamlined in order that they can then to be automated.

**Recommendation:** Streamline and rationalize business processes involving clearance, settlement and depository operations. Streamline and automate the entire electronic infrastructure and operations for the clearance, settlement and depository in an effort to move toward and ultimately achieve straight through processing (STP) and latest next day settlement on all purchases, sales, collateral registrations and releases. Link AZIPS, the central bank's RTGS, to the securities exchange and depository to facilitate same day settlement of corporate and government securities transactions.

## **CORPORATE GOVERNANCE AND PROTECTION OF INVESTORS' RIGHTS**

### **Shareholder Rights**

**Priority Constraint:** While the SCS has had success over the past several years in bringing down the number of reported incidences, alleged violations of investors' rights continue at a concerning rate.

**Recommendation:** Strengthen enforceability of shareholder rights -

- Establish a Department for the Protection of Investors' Rights dedicated to addressing investor complaints and seeking prosecution for violations of the legislative and normative safeguards in place to protect investors' rights.
- Establish a legal framework that allows the SCS to seek orders and/or to take other action to ensure compliance with legislative and normative safeguards to protect investors' rights.

- Review the effectiveness of the current framework for sanctions and if indicated obtain authority to impose greater sanctions on recidivists and for egregious misconduct, etc.
- Establish an “Investors’ Rights / Corporate Governance Compliance Program.”

### **Market Surveillance / Enforcement Capabilities of SCS**

**Priority Constraint:** SCS is without the requisite capability to efficiently and effectively supervise and monitor the conduct of market intermediaries.

**Recommendation:** Enhance market surveillance and enforcement capabilities -

- Streamline and harmonize the responsibilities of the Turnover Regulation Department and Licensing and Supervision Department to avoid gaps and overlaps, etc. (see “Streamline Market Regulation”).
- Aggregate enforcement responsibilities within the SCS (see “Aggregate Enforcement Responsibilities”).
- Establish a legal framework that allows the SCS to carry out inspection of business operations whenever it believes it necessary to ensure compliance with relevant standards.
- Establish a legal framework that allows the SCS to seek orders and/or to take other action to ensure compliance with relevant regulatory, administrative and inspection powers.
- Review the effectiveness of the current framework for sanctions imposed on market intermediaries for violations of relevant standards and if indicated obtain authority to impose greater sanctions.
- Establish an effective compliance program (system) for regulated entities which aims at detecting and deterring securities laws violations.
- Establish on-going and ad hoc monitoring activities which include on site inspections.

### **Reporting of Securities Trades**

**Priority Constraint:** In practice, many “trades” occurring on the stock exchange are in reality previously negotiated transactions that are simply cleared and settled through the stock exchange without transparent reporting, including reporting of the actual trade price.

**Recommendation:** Modify securities regulations, and their enforcement, to require immediate reporting of all securities trades (corporate and government securities), emphasizing reporting of actual market prices, not nominal prices.

### **Establish and Phase-in Capital Requirements on Intermediaries and Stock Exchange Members**

**Priority Constraint:** Currently no minimum capital requirements exist for intermediaries and members of the BSE. Initial and ongoing capital and other prudential requirements should be established for intermediaries and members of the BSE. These requirements

should be phased-in as actions are taken to increase activity occurring in Azerbaijan's capital markets, and as markets themselves grow.

**Recommendation:** Establish and phase-in capital requirements on intermediaries and stock exchange members. Initial and on-going capital requirements should be designed to achieve an environment in which an intermediary and stock exchange member can meet the current demands of their counter parties and, if necessary, wind down without loss to their customers.

### **Managerial Accountability and Financial Reporting Practices**

**Priority Constraint:** Currently only issuers of securities listed on the first tier "quoted" level of the BSE are required to file financial statements in accordance with International Financial Reporting Standards (IFRS) and International Audit Standards (IAS).

**Recommendation:** Strengthen managerial accountability and financial reporting practices. IFRS and IAS should be required for all firms listed on the tier one and tier two "quoted" levels of the BSE, and for all companies participating in secondary markets issuances. At a minimum, these requirements should be phased-in when practicable over the medium-term.

### **Governance of Capital Market Institutions**

**Priority Constraint:** Corporate governance provisions, standards and practices of Azerbaijan's financial market institutions and its market intermediaries fall short of international standards. There are currently no SROs or securities industry associations that are functioning as such in the securities market in Azerbaijan.

**Recommendation:** Ensure that all capital market institutions (intermediaries, exchange, depository (ies), etc.) adopt governance standards that are consistent with international best practice. To accomplish this, either recognize/authorize the BSE to act as an SRO and impose upon it the responsibility to regulate its members or, alternatively, require the recently formed "Association of Participants of Azerbaijani Stock Market," of which the BSE is a member, whether as an SRO or an / the securities industry association to be responsible to adopt rules of ethical conduct for its members and to monitor their conduct. Depending on the course the SCS determines to pursue, the SCS should also consider requiring all licensed securities market participants to be members of the (securities industry) SRO or association.

### **Corporate Finance**

**Priority Constraint:** The legislative infrastructure supporting corporate finance needs improvement. The current legislative structure for corporate finance is inadequately developed.

**Recommendation:** Streamline and clarify the legal framework for private placements. Private placements are permitted under the civil code, but that process is almost entirely undeveloped and undefined in the regulatory framework. Joint stock companies financed through a private placement process might then provide a more fertile breeding ground for open joint stock companies that could truly benefit from the financial intermediation a national exchange could offer.

### **Trading of Securities by Non-licensed Parties**

**Priority Constraints:** Currently individuals are allowed to trade securities directly among themselves; additionally, if such a transaction is not concluded by a broker or one of the parties is not a dealer, the parties are allowed to conclude the transaction through a notary.

**Recommendation:** Rationalize and modify off-exchange trading privileges such that all notary and private-party transacted trades clear and settle ‘next day’ with full price reporting required for all ‘off-exchange’ trades. Require all off-exchange trades to be settled through the securities market’s clearance and settlement system. Following settlement, safe-keep settled securities at central securities depository.

### **Company Reporting Requirements**

**Priority Constraint:** While public reporting companies (OJSCs) are required to file annual periodic reports and information on events having substantial impact on their financial and economic activities with the SCS, and there are provisions for publication in mass media after approval by the SCS, the law does not provide an effective mechanism for the SCS to force observance of the disclosure requirements.

**Recommendation:** In context of the recommendations discussed above to strengthen and enforce investors’ rights (see “Shareholder Rights”), rationalize the disclosure requirements for public companies to reduce the current large number of companies required to file annual reports with the SCS without demonstrable impact on potentially affected shareholders.

### **Financial Analytical Capacity at SCS**

**Priority Constraint:** At present the staff of the SCS lacks the financial analytical capacity to effectively analyze the financial and other reports filed by Open Joint Stock Companies (OJSC) whose securities are located on the exchange.

**Constraint Analysis:** Without the requisite financial analytical capacity of its staff to analyze the financial reports filed by OJSCs, the SCS is unable to effectively protect investors’ rights.

**Recommendation:** Improve financial analytical capacity at the SCS in the near-term, then deploy that new capacity monitoring and analyzing reporting from Open Joint Stock Companies whose securities are located on the exchange. To accomplish this leverage upon knowledge and the resource capabilities of the Ministry of Finance to support

development of the financial analytical and other accounting skills that are required within the SCS.

### **Regulation of Collective Investment Schemes (CIS)**

**Priority Constraint:** While the legal framework nominally allows for CIS, there are currently no CIS operating in Azerbaijan. To jump-start establishment of CIS, the current legal framework needs to be substantially improved or replaced by a new Law on Investment Funds and the staff of the SCS and licensed securities market participants need to be trained. The investing public needs to be made aware of the value of CIS to them and the enhanced capacity of the SCS to regulate CIS.

**Recommendation:** Once the existing legal framework for CIS is substantially improved or replaced, strengthen the capacity of staff at the SCS to regulate Collective Investment Schemes (CIS), particularly initial issuance and supervision/regulation of usual trouble spots such as valuation, rights of redemption and custody verification of assets.

## **STRENGTHEN SUPPLY OF FINANCIAL PRODUCTS**

### **Expand Inter-bank Trading of Government Securities and Public Investment in Government Securities**

**Priority constraint:** The inter-bank market for National Bank Notes and Ministry of Finance T-bills is currently not liquid. Banks are constrained from conducting sufficient desired levels of inter-bank government securities trading as a result of a variety of factors (see “Commercial Bank/Central Bank Access to Government Securities Market”), and domestic private investment in the government securities market is limited.

#### **Recommendation:**

- Remove market friction by opening up direct participation in primary and secondary market trading of government securities to all licensed commercial banks and the central bank.
- Increase volume of primary issuances by the Ministry of Finance, in all maturity ranges.
- Strengthen demand for Government of Azerbaijan T-Bills by providing support to Ministry of Finance to help them move toward best practices in government debt issuance, in particular emphasizing issuance planning, issuance practices, and yield curve development aimed at creating a more reliable primary market to attract a broader base of investors in Azerbaijan government securities.
- Expand volume of secondary market interbank trading in government securities by shortening settlement time through linking the AZIPS to the BSE and the depository, redesigning government securities clearance and settlement processes, then automating the clearance and settlement of government securities.

## **Collective Investment Schemes (CIS)**

**Priority Constraint:** Azerbaijan's current legal framework nominally allows for collective investment schemes, but to jump-start CIS the legal framework will need to be substantially improved or replaced. Regulatory staffs are unschooled in CIS and untrained / inexperienced in regulating CIS. Investment managers, brokers and dealers are not sufficiently familiar with Collective Investment Schemes. The investing public is insufficiently aware of the existence of value of collective investment schemes, and unaware of the SCS' capacity to regulate CIS.

### **Recommendation:**

- SCS staff receives assistance and support in reviewing, revising (as needed) and completing / or replacing the existing skeletal legal and regulatory framework governing CIS.
- SCS staff receives extensive training in the supervision and regulation of CIS, with particular emphasis on regulation of asset valuation, CIS reporting to regulators and investors, and enforcing best-practice custodial regulations.
- Investment managers, depositories and registrars together with other relevant professionals including Chamber of Auditors/auditors, brokers and dealers/members and staff of BSE are trained on the (substantially) revised or replaced legal framework for registration and operation of CIS.
- Investment Managers, Brokers, Dealers, BSE and SCS work together to initiate the issuance of a Collective Investment Vehicle.
- Launch a public awareness campaign to educate the public in the benefits of investing in CIS.

## **Expand Corporate Securities Issues**

**Priority Constraint:** Five or six of the better managed, more transparent and well capitalized firms traded in the BSE raised additional capital in the past year by re-issuing shares or issuing new corporate bonds. Most of these issues came from rapidly growing Azeri banks. Financial intermediation is occurring, according to existing securities and company law and current practices in the financial markets. However, there is significant room for improvement.

### **Recommendation:**

- Thoroughly rewrite all existing private placement regulation and stock/bond market issuance procedures, distinguishing between private placements and stock/bond market issuances through the organized financial markets (BSE, Depository, etc.).
- Rationalize issuance procedures for both market segments (public offerings and private placements), bringing practices more in-line with international best practice.
- Banks, brokers and dealers work together to expand free-float in existing corporate stock and bond issues and expand public awareness of existing securities issues.
- Brokers and dealers work together to expand trading in those existing issues.
- Brokers and dealers create new high-quality corporate equity and bond issuances.

To overcome the above priority constraints and implement the recommendations set forth above will require comprehensive tactical reorganizations within the SCS.

## **COMPREHENSIVE TACTICAL REORGANIZATIONS WITHIN THE STATE COMMITTEE FOR SECURITIES**

### **Establish Public Relations Function within Administration Department**

**Priority Constraint:** At present there is no public relations function within the SCS.

**Recommendation:** Under the existing Administration Department, ensure that ‘Secretariat-type’ functions are addressed, including: public relations, a spokesperson for the SCS, management of international relations, a secretary that provides public notice of meetings and minutes of meetings, etc.

### **Establish Department for Protection of Investors’ Rights**

**Priority Constraint:** At present there is no Department for Protection of Investors’ Rights within the SCS.

**Recommendation:** Establish a Department for Protection of Investors’ Rights to ensure increased monitoring and enforcement of corporate governance provisions of issuer communications, periodic reports, shareholder voting information, tender offers, collective investment instruments, etc.

### **Streamline Market Regulation**

**Priority Constraint:** At present the regulation and supervision of licensed securities market participants (i.e., brokers and dealers, exchanges, clearing facilities, depositories, registries, etc.) appears to be spread across the Turnover Regulation Department and Licensing and Supervision Department.

**Recommendation:** Streamline and harmonize the responsibilities, processes and procedures of the Turnover Regulation Department and Licensing and Supervision Department such as to prevent functional and procedural gaps and overlaps and ensure greater overall operational efficiency and effectiveness in regulating and supervising licensed market participants. The objective is to establish and maintain (through processes and procedures established by SCS) standards conducive to fair, orderly, efficient and safe markets, primarily through the supervision and regulation of licensed securities market participants. In the medium term, to achieve greater economies of scale, we also recommend the SCS considers combining the current Turnover Regulation Department and Licensing and Supervision Department and establishing a consolidated “Market Regulation Department.”

### **Aggregate Enforcement Responsibility**

**Priority Constraint:** At present “enforcement” responsibilities appear to be spread across several departments within the SCS including the Legal Department and Licensing and Supervision Department, and there is no one department or specialized division within one department of the SCS which has exclusive responsibility for activities related to enforcement of the legal and regulatory framework that comprise the securities laws and ensure the protection of investors’ rights in Azerbaijan.

**Recommendation:** Establish a separate department or specialized division within one department (we recommended the Legal Department) of the SCS which has exclusive responsibility for enforcement activities including review of complaints, formal and informal investigations, the conduct of administrative proceedings and revocation and suspension proceedings, and the review of cases to be referred under criminal provisions against individuals and entities. The separate department or division of the Legal Department should also be responsible for requests for confidential treatment and access to SCS files relating to enforcement matters. While it appears that the range of activities for which the proposed separate department or division of the Legal Department should be responsible are currently covered in large part between the Legal Department and Licensing and Supervision Department, we believe that the benefits to be derived from establishing a separate department or division within the Legal Department which has exclusive responsibility for enforcement activities should be realized going-forward and, if practicable, within the near-term.

### **Devolve Certain Responsibilities to the BSE and Broker-Dealer Community**

**Priority Constraint:** While current legislation provides for self-regulatory organizations of professional participants of the securities market (SROs), and the BSE has in large part assumed the responsibilities placed upon it under the Civil Code, there is more that the BSE (and its membership) could be encouraged and empowered do as an SRO to fulfill its statutory purpose to protect the interests of investors.

**Recommendation:** Gradually, over the long-term, devolve some of the functions of the current Analysis and Market Department (e.g., performing economic and trend analyzes of activities in the securities markets) from the SCS to the BSE and the broker-dealer community (also see “Governance of Capital Market Institutions”). In this regard, the recently formed “Association of Participants of Azerbaijani Stock Market,” of which the BSE is a member, could also be considered to play an appropriate role in devolvement of some of the functions of the current Analysis and Market Department to the broker-dealer community, and as an SRO or securities industry association. .

### **Strengthen Accounting Linkages with the Ministry of Finance**

**Priority Constraint:** While the Ministry of Finance is the regulatory oversight body which sets the standards for accounting in Azerbaijan, all public (open joint stock) companies are required to file their annual financial reports with the SCS.

**Recommendation:** Strengthen institutional linkages between accountants within the SCS and the accounting standards and accounting enforcement personnel at the Ministry of Finance.

## II. CAPITAL MARKET OVERVIEW

### CURRENT FINANCIAL INTERMEDIATION AND MARKET INFRASTRUCTURE

The following table, provided by the Baku Stock Exchange (BSE), summarizes primary and secondary market activity on the BSE during 2008.

Based upon 240 trading days during 2008, it is evident that the number of secondary market transactions in *corporate securities* on the BSE is small, averaging less than nine transactions per day in all corporate markets combined. The corporate market has no liquidity. Of the 2.785 billion Manat in non-repo turnover at the BSE in 2008, corporate securities trading volume comprised only 240

<b>2008 Primary and Secondary Market Trading on the Baku Stock Exchange</b>		
<b>Market</b>	<b>Volume<sup>1</sup></b>	<b>No. of Transactions</b>
<b>Primary Market</b>		
T-Bills	298.6 million	236
National Bank Notes	1.638 billion	359
Corporate Bonds	32.4 million	46
Corporate Shares	173.8 million	1,170
<b>Totals</b>	<b>2.143 billion</b>	<b>1,811</b>
<b>Secondary Market</b>		
T-Bills	128.2 million	96
National Bank Notes	453.5 million	742
Corporate Bonds	15.3 million	205
Corporate Shares	18.4 million	602
<b>Totals</b>	<b>615.4 million</b>	<b>1,645</b>
Repo transactions	6.761 billion	1,767

million Manat, or 8.7%. The transaction volume sustaining the business operations of BSE and its related institutions and firms is composed predominantly of trades in T-Bills and National Bank notes. Nonetheless, even the comparatively greater government securities trading volume is not nearly sufficient to achieve liquidity the government securities market or a reliable government securities yield-curve –fundamental building blocks of a corporate bond market.

#### **Government Securities Market**

Currently the National Bank is the largest issuer of government securities.<sup>2</sup> The central bank conducts its liquidity management and sterilization program in large part through the issuance of National Bank Notes.<sup>3</sup> The Ministry of Finance is a much smaller issuer of

<sup>1</sup> In Azerbaijan Manat. As of January 26, 2009, one US dollar equals 0.81 Manat.

<sup>2</sup> Primary offerings of National Bank notes increased in 2006 and 2007 but declined over [25] % in 2008.

<sup>3</sup> Ownership and trading in National Bank notes is limited to domestic commercial banks.

government securities, with no regular, predictable program for issuance.<sup>4</sup> Both institutions predominantly issue securities in the in the one-month maturity range. The primary issuances from both institutions exclusively trade, clear and settle on the Baku Stock Exchange. All government securities are safe-kept at the Baku Stock Exchange; none are safe kept at the National Bank of Azerbaijan.

From a business perspective, Azerbaijan's government securities market is underwriting the ongoing operational costs of for the under-used infrastructure of the corporate securities market, including the regulatory apparatus, trading system, depositories, and clearance / settlement systems. From a policy perspective, trading, clearing, settling and safe keeping government securities outside the central bank is not best practice, nor is conceding regulatory authority for the day-to-day operations of the government securities market to the (nominal) corporate securities market regulator consistent with global best practice. However, there is little immediate risk of 'event penalty' resulting from the current approach.

Rather the risk lies in the loss of opportunity. Approximately 60% of trading in Ministry of Finance issued T-Bills is attributable to *foreign investors*.<sup>5</sup> As the economy of Azerbaijan further integrates with the global economy, the Ministry of Finance and the National Bank could easily seek to revert to more standard global practice and shift both the primary and secondary government securities market trading, cleaning and regulatory apparatus under the National Bank. The current 'sanctuary' era of a subsidized corporate securities infrastructure may be short-lived, but almost certainly will not persist indefinitely. It is therefore crucial that the corporate securities market take maximum advantage of the current 'free ride' period to develop is functional capacity.

### **Corporate Securities Market**

Values shown for corporate securities traded on the stock exchange are equal to less than one-half of one-percent of Azerbaijan's GDP. More importantly, much of the corporate securities volume that clears through the exchange does so in order to meet technical and legal requirements – not to take advantage of the exchange's price discovery mechanism or the reserves of investible capital represented by the exchange's members and customers.

According to market participants, the exchange does not serve as a price discovery mechanism or a meeting place for buyers or sellers. In fact, neither price discovery or price signaling occur in the corporate securities market, because current market regulations do not require reporting actual trade prices, nominal prices are accepted. Financial intermediation is currently occurring for some listed open joint stock companies (OJSC), but that intermediation process occurs entirely outside the exchange with pre-arranged participants. A final step in the settlement process of the corporate finance transaction requires clearing the exchanged securities through the BSE and its affiliated clearance and settlement institutions. In these transactions that result in financial intermediation, the 'value added' from the exchange itself is negligible; instead the value derived from the

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<sup>4</sup> Beginning from a very small base, Ministry of Finance issued T-Bills have increased each of the last three years

<sup>5</sup> Additionally, approximately another 30% to of T-Bills are owned by domestic commercial banks.

securities institutions is attributable to the secure registration of the new securities at the securities depository.

Some of the 35 companies whose shares are listed on the BSE raised fresh capital in 2008 through securities transactions that cleared through the BSE. 90% of those listed companies that raised additional capital through exchange-related transactions were financial sector businesses - over 75% of these issuances of corporate equity and debt benefitted domestic banks. Insurance and leasing companies accounted for about 15% of new intermediation through issuance of securities.

The issuance of additional shares or bonds to raise capital for listed companies, is achieved through a process that in all ways is consistent with a private placement, except that the final step in the negotiated transaction requires the principals of the transaction to send certain data<sup>6</sup> through the exchange so that the 'trade' can be reported, cleared and settled through the exchange, and the shares registered at the depository. In addition to corporate securities trading comprising a minor share of trading on what is essentially a government securities exchange, much of the corporate 'trading' that does currently occur is actually a final step appended to a private placement, corporate finance transaction.

## **RELEVANT CONSTRAINTS IN LEGAL AND REGULATORY FRAMEWORK**

Relevant constraints in the legal and regulatory framework by subject area include:

### **Issuance and Trading in Government Securities**

Under existing procedures, when issuing and trading in government securities, there is no exception for commercial banks from the requirement to conduct activities through broker or dealers. Banks seeking to trade government securities with other commercial banks are required to negotiate the trade through a broker or dealer, execute, clear and settle the transaction on the stock exchange, and safe-keep the government securities not at the central bank, but instead at the stock exchange's depository. Overseas institutional investors that invest in Government of Azerbaijan T-Bills or National Bank Notes must safe-keep those securities at the corporate depository as well, in deviation from standard international practice of safe-keeping government securities at the nation's central bank.

### **Inspection and Enforcement Powers of SCS**

Current regulations do not clearly permit SCS to:

- Conduct on-site inspections of licensed market participants
- Impose sanctions on the level that may be required to obtain compliance with legislative and normative acts to protect investors' rights
- Seek orders and/or take other action to ensure compliance with legislative and normative acts to protect investors' rights

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<sup>6</sup> Not necessarily even price data

### **Protection of Investors' Rights and Related Issues**

Current regulations do not provide for:

- Disclosure of the identity and holdings of persons who hold a substantial "beneficial" ownership in the company
- Circumstances in which a mandatory tender offer must be made to all shareholders
- Disclosure of information in connection with a change in corporate control (e.g., a take-over, etc.) to enable minority shareholders to assess the offer
- A framework that requires an issuer to change external auditors after a certain number of years

### **Capital Requirements for Intermediaries**

At present, there are no initial and on-going capital requirements for brokers and dealers and members of the BSE. International best practice indicates that initial and on-going capital requirements should be imposed on licensed intermediaries that are designed to achieve an environment in which the intermediary can meet current demands of its counter parties and, if necessary, wind down without loss to its customers.

### **Financial Reporting and Accounting Standards**

National Accounting Standards are not sufficient to support the level of financial information, knowledge and confidence required to increase financial intermediation on the Baku Stock Exchange (BSE) exchange. To strengthen managerial accountability and company financial reporting practices, International Financial Reporting Standards (IFRS) and International Auditing Standards (IAS) should be required when practicable for all issuers whose securities are listed on tier one and tier two of the BSE, and for all companies participating in secondary markets issuances.

### **Private Placement Transactions**

The current legislative structure for corporate finance is inadequately developed and the process of financial intermediation outside the exchange is constrained by the lack of a sound private placement law and regulation. Private placements are permitted under the civil code, but that process is almost entirely undeveloped and undefined in the regulatory framework.

### **Trade Reporting Practices**

In the past year, five or six firms traded on the BSE raised additional capital by issuing additional shares (a secondary offering of shares) or issuing new corporate bonds. Such practices amounted to little more than a private placement of securities to existing shareholders and investors. Outdated and inefficient procedures in the capital market prevent the exchange and its associated institutions from adding significant value to the financial intermediation process, resulting in the exchange/depository serving as little more than a final stopping point for the issuer and investor to register the new shares or bonds. Since reporting of share/bond price data is not required by existing regulation, even the most basic data from the transactions are not made available to the investing public, preventing rational decisions about investment or resource re-allocations by investors.

### **Individual Transactions**

Currently individuals are allowed to trade securities directly among themselves; additionally, if the transaction is not conducted by a broker or one of the parties is not a dealer, the parties are allowed to conclude the transaction through a notary. Individuals that trade securities among themselves are not required to submit the transaction information to the registry, depository or central securities lien registry on a timely basis; the same constraint exists for trades transacted through notaries. As a result, registry, depository and lien registry records do not contain comprehensively accurate ownership records.

### **Collective Investment Schemes (CIS)**

While Azerbaijan's legal framework nominally allows for collective investment schemes (CIS), the current legal framework fails to support a market in CIS and should be substantially upgraded or replaced in line with international best practice for CIS.

### **Company Law Provisions of the Civil Code**

Chapter 4 of the Civil Code (entitled "Legal Entities") serves as Azerbaijan's company law. While it is in many respects a well written and comprehensive piece of legislation, it lacks in some places the clarity that many investors seek.

Firstly, the law's provisions regarding the conduct of shareholder meetings is vague with regard to the extent to which shareholders may vote "cumulatively" for members of the Board of Directors. "Cumulative voting" refers to the right of the shareholders to pool their votes so as to concentrate them on the election of one or more directors, as opposed to applying their votes to the election of all directors. This is an important right for minority shareholders, who know that they will never control a company's board of directors, but nonetheless want at least one or two members of the board to be aligned with their interests.

Although Article 107-3.5 of the Civil Code does provide for "one share-one vote," Article 107-7 does not expressly state how those votes are to be allocated. A much more investor-assuring law would expressly and comprehensively set forth the voting mechanics prerequisite to the election of the board of directors, as well for all other business that comes before the General Meeting of Shareholders.

Secondly, the law, at Article 107-5.2, provides for conveyance of decisions "accepted" by the General Meeting of Shareholders within 15 days. The law does not set forth any required means of such conveyance, and it does not state whether the shareholders must receive such notice within the said 15-day period. While companies may provide for these items in their charters (see, generally, Article 102.2), there is no requirement that they do so. A provision in the law would aid those companies (and the shareholders thereof) that have failed to address "notice" questions in their charters, and it could serve as a "threshold," or "minimum" requirement. Disputes involving the sending and receiving of notices form the basis of many lawsuits in western countries, and Azerbaijan would do well to avoid them to the extent possible by assuring clarity in the law.

Thirdly, the law does not appear to require that all decisions be communicated to shareholders. This can be off-putting to shareholders who do not plan to participate in the General Meeting of Shareholders.

Fourthly, and perhaps most troublingly, Article 107-1.3 requires that the Board of Directors of a Joint Stock Company convene the annual General Meeting of Shareholders not later than six months after the end of the financial year. While the six-month period is, by itself, not troubling, the annual General Meeting appears to be the only device by which financial reports are distributed to shareholders (see Article 107.1.4). This presents two difficulties: (i) An annual General Meeting of Shareholders is unlikely to provide a forum within which shareholders may exhaustively review financial reports and prepare questions. Moreover, even if it were, it certainly is not a forum within which they might expect to receive meaningful answers. (ii) Financial information that is more than a half-year old may not prove sufficiently informative. Thus, the law should be re-written to require that financial reports be completed within two months of the end of the financial year and should be communicated to shareholders within 15 days thereafter. Also, the law should not permit the annual General Meeting of Shareholders to be convened prior to the communication of financial statements to shareholders.

The law also appears to be fraught with a number of small technical (as opposed to substantive) errors that should be remedied by way of a Technical Corrections Amendment. For example, it appears to contain a conflict as to who is entitled to convene General Meetings of Shareholders (see Article 106-1.3.3 and Article 107-1.3), and it does not appear to contain provisions for the conduct of Extraordinary General Meetings (although these were clearly envisioned; see Article 107-1.6).

In sum, and with a view toward ensuring investor certainty, the SCS and relevant ministries should undertake an effort to review the entirety of Chapter 4 of the Civil Code, and to re-write the articles thereof that address Joint Stock Companies and the rights and responsibilities of their shareholders with a view toward clarity, predictability, and the swift resolution of inter-shareholder and shareholder-company disputes.

### **Securities Law Provisions of the Civil Code**

Chapter 54 of the Civil Code is entitled “Securities.” It aims to govern “documents” that “certify rights” in contexts in which the rights are not present in the absence of the operative document (Article 987.1). It is analogous to laws in western countries that (i) address the ownership and transfer of certificated shares of companies; and (ii) address the creation, form, negotiation (i.e., transfer without recourse), and liabilities created by what is commonly known as “commercial paper.”

Generally, Chapter 54 represents an adequate effort at drafting legal provisions that serve the purposes set forth above. There are several articles that should be re-worked so as to make them more compatible with international practice. Also, the entire chapter should be made the subject of a Technical Corrections Amendment.

As an example of an article that requires re-working, Article 997.1 sets forth the types of securities that are recognized in Azerbaijan. The provisions thereof are generally consistent with international practice, except for the Article's failure to include "Documents of Title" such as bills of lading, warehouse receipts, and other documents that evidence possession of goods and contracts to deliver them.<sup>7</sup> Such inclusion will (i) greatly facilitate letter of credit financing, as international banks generally use and understand these phrases, and they will be reluctant to alter their form letter of credit documentation to conform with Azerbaijani law; (ii) increase the amount and types of securitized instruments available in Azerbaijan; and (iii) serve a valuable investor education function.

The requirement for technical corrections arises largely from what appears to be disparate drafting efforts undertaken over the course of several years. A serious technical corrections effort (perhaps conducted by local lawyers working in concert with a foreign or local senior commercial lawyer) will increase investor (and tradesman) confidence and predictability, and will greatly enhance the prospect for swift resolution of disputes that do occur.

### **III. RECOMMENDATIONS FOR SECURITIES MARKET DEVELOPMENT**

#### **(1) IMPROVE THE MARKET'S ORGANIZATION AND OPERATIONAL INFRASTRUCTURE**

##### **Commercial Bank/Central Bank Access to Government Securities Market**

**Current Status:** The financial industry in Azerbaijan is compartmentalized in a rational fashion, with commercial banking separated from investment banking/securities. However, no exception exists with regard to government securities. The result is that commercial banks must work through securities market intermediaries and institutions. As a result, commercial banks access the government securities market exclusively through licensed securities brokers or dealers. Primary market issuances of government securities, secondary market trades in government securities and the government securities repo markets all require banks to work through licensed securities dealers or dealers.

**Constraint Analysis:** To comply with this constraint, many commercial banks formed subsidiary broker or dealer institutions. These institutions are not only financially undercapitalized, particularly compared to commercial banks, but lack comparable human capital.

When monetary conditions require the central bank to drain liquidity from the banking system, it is forced to execute reverse-repos of government securities with commercial banks with the banks being required to go through brokers or dealers to communicate with the central bank, not directly with the central bank. Banks seeking to trade government securities with other commercial banks are required to negotiate the trade through a broker

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<sup>7</sup> While the Article does list "commodity documents," such phrase appears to be undefined anywhere, and it is not clear whether the phrase means conventional bills of lading.

or dealer, execute, clear and settle the transaction on the stock exchange, and safe-keep the government securities not at the central bank, but instead at the BSE securities depository.

Overseas institutional investors that invest in Government of Azerbaijan T-Bills or National Bank Notes must safe-keep those securities at the BSE securities depository as well, in deviation from standard international practice of safe-keeping government securities at the nation's central bank. This imposition of an extra, unneeded layer in government securities transactions increases market friction, decreases market efficiency, and thereby reduces the capacity of the government securities market to meet the monetary management needs of the central bank or to grow and thereby assist with the development of the corporate securities market.

**Prioritized Recommendation:** Grant an exception (amend the Civil Code) to allow commercial banks to deal directly when executing government securities trades (including primary issuances, secondary market trades, repos, etc.) with other commercial banks or with the central bank without a broker or dealer involved in the transaction. Granting an exception for the issuance and trading of all government securities to banking sector institutions is a high priority recommendation. Migration to the central bank of clearance, settlement and safekeeping of government securities is a lower order priority and should be accomplished when practicable over the medium-term.

**Benefit to Capital Market Development:** A liquid government securities market that establishes a yield-curve is an excellent foundation for the development of a corporate securities market. Taking steps to achieve a well-developed government securities market provides the foundation for successful efforts to build a corporate securities market.

### **Licensed Securities Depositories**

**Current Status:** Currently there are three licensed central securities depositories in Azerbaijan. Two of the central depositories handle only corporate securities. The third central depository, located inside the BSE, performs depository functions for all government securities and performs no depository functions for corporate securities.

**Constraint Analysis:** The existence of two corporate securities depositories undermines the core benefit of a central depository - its central status as a registry and depository for all registered securities. Owners, lenders, creditors and the courts can never be certain of a security's ownership status without simultaneously checking the records at both depositories. The separation of the corporate depository from the government securities depository is not a particular constraint, but combining them could add efficiencies, particularly given capacity constraints.

**Prioritized Recommendation:** Consolidate all three central depositories into one licensed central securities depository for government securities and corporate securities. This depository may be two-tiered, or feature remote locations with full electronic linkage back to the central location in Azerbaijan, but it is essential to reduce the number of corporate

securities depositories to one, and it is currently useful to co-locate the government securities depository with the corporate securities depository.

**Benefit to Capital Market Development:** Slow turnaround time on clearance and settlement of securities transactions, and lack of certainty of completeness of ownership records at a given depository is exacerbated by the existence of multiple securities depositories, along with other factors. Reductions in transaction time, and greater surety of accuracy of ownership records can be facilitated through the creation of a central securities registry. A reliable source of ownership records and next-day turnaround on securities trades and ownership modifications greatly facilitate the development of a nation's capital market.

### **Central Securities Lien Registry**

**Current Status:** Currently Azerbaijan's central lien registry, a state organization, is located inside the State Committee for Securities. This central lien registry records liens against all types of securities. The central lien registry is responsible for attaching and registering a lien on the asset inside the registry where the asset is registered. Additionally, there is a lien registry within one of the departments of the SCS which records liens against house certificates, mortgage certificates, guarantees, and collateral of other types which are non-securities.

**Constraint Analysis:** Because corporate and government securities are spread among three depositories, the central lien registry must identify the location of the security before it begins the lien registration or release process, and because the lien registry is located outside of each depository, turnaround times for lien registrations and releases can be longer than should be required. Additionally, because the securities functions of the central lien registry are not electronically integrated into a central securities depository, the time and effort required to settle a transaction is potentially greater than international norms. Lastly, locating a non-securities related lien registry within one of the departments the SCS tends to dilute resources from within the SCS which could be focused on the essential functions of the SCS.

### **Prioritized Recommendation:**

- First, move the central lien registry outside of the State Committee for Securities and locate and integrate its activities with those of a consolidated central depository.
- Second, migrate all functions, business processes and records of the central securities lien registry to an electronic format.
- Third, seamlessly integrate the functions and business processes of the state central securities lien registry with respect to liens on securities into the business processes of a consolidated central securities depository, trading system and clearance & settlement system.

Fourth, as soon as practicable, move all non-securities related lien registration activities outside of the SCS and to a more suitable locate such as the State Movable Property Registry which is currently under development.

**Benefit to Capital Market Development:** Much of the benefit to a capital market lien registry is the comprehensiveness of its records. Unless a capital market lien registry's records are comprehensive and cover all registered securities, then it detracts from the viability of the capital market. A central, comprehensive securities lien registry whose records and operations are integrally enmeshed in the operations of a central depository, clearance and settlement régime will allow a capital market to function in a manner required by international investors, given that other required conditions are also met.

### **Securities Clearance and Settlement Operations**

#### **Business Processes Issues:**

**Current Status:** Business processes involving clearance and settlement are designed around manual operations. These business processes need to be streamlined in order that they can then to be automated.

**Constraint Analysis:** Secondary market trades of corporate securities can sometimes take longer than should be required to transact and settle at the BSE, and require multiple visits to the relevant institutions. This tends to slow down and discourage trading activity on the BSE and may be a contributing factor in the preference for off-exchange transactions and private placement capital financings.

**Prioritized Recommendation:** Streamline and rationalize business processes involving clearance, settlement and depository operations.

**Benefit to Capital Market Development:** When the business operations governing clearance and settlement are streamlined (and not before), automation of those processes can begin. Capital market development cannot realistically commence until the securities clearance and settlement process is successfully automated.

#### **Operational Issues:**

**Current Status:** Much of the BSE's clearance and settlement operations are manual, and are not integrated with other key operating functions such as trading, lien registration and release, etc. Furthermore, clearance and settlement operations of the BSE and its depository and those of the two other depositories are not integrated with AZIPS<sup>8</sup>, a real time gross settlement system (RTGS) operated by the central bank. Automated linkages between exchange members to the BSE's clearance and settlement operations and depository, for example, do not exist

**Constraint Analysis:** Sellers and buyers, and capital market participants can not place, transact, or clear and settle trades in an expeditious or automated manner. This is a significant constraint to the operation and growth of Azerbaijan's capital market.

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<sup>8</sup> The Azerbaijan Interbank Payment System (AZIPS) operated by the central bank.

**Prioritized Recommendation:**

- Streamline and automate the entire electronic infrastructure and operations for the clearance, settlement and depository in an effort to move toward and ultimately achieve straight through processing (STP)<sup>9</sup> and latest next day settlement on all purchases, sales, collateral registrations and releases.
- Link AZIPS, the central bank’s RTGS, to the securities exchange and depository to facilitate same day settlement of corporate and government securities transactions.

**Benefit to Capital Market Development:** Automating the trading, clearance and settlement of securities in Azerbaijan will signal to participants inside and outside of Azerbaijan that Azeri capital markets warrant further consideration to determine their market-worthiness.

**(2) STRENGTHEN DEMAND BY REINFORCING GOVERNANCE****Shareholder Rights**

**Current Status:** While the SCS has had success over the past several years in bringing down the number of reported incidences, alleged violations of investors’ rights continue at a concerning rate.

**Constraint Analysis:** Securities holders should be treated in a fair and equitable manner, and should receive full, timely, and accurate disclosure of financial results and other information important to investors’ decisions. Full disclosure of information material to investors’ decisions is the most important means for ensuring investor protection. Chapter 4 of the Civil Code lacks in some places the clarity that many investors seek (see “Company Law Provisions of the Civil Code”).

**Prioritized Recommendation:** Strengthen enforceability of shareholder rights:

- Establish a Department for Protection of Investors’ Rights (see below “Establish Department for Protection of Investors’ Rights”) dedicated to addressing investor complaints and seeking prosecution for violations of the legislative and normative safeguards in place to protect investors’ rights.
- There should be an efficient and effective mechanism for the resolution of investor complaints.
- Establish a legal framework that allows the SCS to seek orders and/or to take other action to ensure compliance with legislative and normative safeguards to protect investors’ rights.
- Review effectiveness of the current framework for sanctions imposed on companies for violations of investors’ rights and, if indicated, obtain authority to impose greater sanctions on recidivists and for egregious misconduct, etc.

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<sup>9</sup> **Straight Through Processing (STP)** enables the entire trade process for capital markets and payment transactions to be conducted electronically without the need for re-keying or manual intervention, subject to legal and regulatory restrictions. When fully realized, STP provides asset managers, broker/dealers, custodians, banks and other financial services players with tremendous benefits, including greatly shortened processing cycles, reduced settlement risk and lower operating costs.

- Publish notice to all securities holders of the investors' rights afforded them under the laws of Azerbaijan.
- Publish notice to all public (open joint stock) companies of the obligations placed upon them under the laws of Azerbaijan to safeguard investors' rights.
- Establish and publish notice to all public (open joint stock) companies of a "new" investors' rights / corporate governance compliance program that would grant amnesty to past violators who come forward in exchange for their undertaking to comply with the requirements of the program going-forward.
- Publish information on actions against and sanctions imposed on companies violating investors' rights.
- Champion adoption of a Corporate Governance Code for Azerbaijan.
- Under auspices on the BSE and its membership, consider to establishment of a Directors' Association and adoption of best practice standards for company directors.
- Initial and on-going capital requirements should be imposed on licensed intermediaries that are designed to achieve an environment in which the intermediary can meet the current demands of its counter parties and, if necessary, wind down without loss to its customers (See below, "Establish and Phase-In Capital Requirements on Intermediaries and Stock Exchange Members").
- Redraft Chapter 4 of the Civil Code (i.e., the company law provisions) to enhance protection of investors' rights.

**Benefit to Capital Market Development:** Protection of investors' rights and fair, efficient, transparent and well-regulated markets are crucial to the formation of capital.

### **Market Surveillance / Enforcement Capabilities of SCS**

**Current Status:** The SCS is without the requisite capability to efficiently and effectively supervise and monitor the conduct of market intermediaries.

**Constraint Analysis:** The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

**Prioritized Recommendation:** Enhance the market surveillance and enforcement capabilities of the SCS:

- Streamline and harmonize the responsibilities of the Turnover Regulation Department and Licensing and Supervision Department to avoid gaps and overlaps, etc. (see "Streamline Market Regulation").
- Aggregate enforcement responsibilities within the SCS (see "Aggregate Enforcement Responsibilities").
- Establish a legal framework that allows the SCS to carry out inspection of business operations whenever it believes it necessary to ensure compliance with relevant standards (the SCS might consider delegating such authority to a SRO such as the BSE). Suspicion of a breach of law should not be a necessary prerequisite to use inspection powers in respect of licensed persons or entities.

- Establish a legal framework that allows the SCS to seek orders and/or to take other action to ensure compliance with relevant regulatory, administrative and inspection powers.
- Review the effectiveness of the current framework for sanctions imposed on market intermediaries for violations of relevant standards and, if indicated obtain authority to impose greater sanctions.
- Establish an effective compliance program (system) for regulated entities which aims at detecting and deterring securities laws violations.
- Establish on-going and ad hoc monitoring activities which include on site inspections.
- Devolve certain monitoring, compliance and reporting responsibilities to the BSE (see below “Devolve Certain Responsibilities to the BSE and Broker-Dealer Community”).

**Benefit to Capital Market Development:** Increased confidence in the capability of the SCS to protect investors’ rights of investors will lead to increased investor confidence and, in turn, increased activity in the capital markets.

### **Reporting of Securities Trades**

**Current Status:** In practice, many “trades” occurring on the stock exchange are in reality previously negotiated transactions that are simply cleared and settled through the stock exchange without transparent reporting, including reporting of the actual trade price.

**Constraint Analysis:** Transparency of trading is, in essence, the degree to which information about trading (both for pre-trade and post-trade information) is made available on a real-time basis. To ensure a trading environment that fosters investment activity, regulation should promote transparency of trading and ensure that the integrity of trading is maintained through fair and equitable rules that strike a balance between the demands of different market participants.

**Prioritized Recommendation:** Modify securities regulations, and their enforcement, to require immediate reporting of all securities trades (corporate and government securities), emphasizing reporting of actual market prices, not nominal prices.

**Benefit to Capital Market Development:** Transparent trading practices and timely access to relevant information about secondary trading allows investors to better look after their own interests and reduces the risk of manipulation or other unfair trading practices.

### **Establish and Phase-in Capital Requirements on Intermediaries and Stock Exchange Members**

**Current Status:** Currently no minimum capital requirements exist for intermediaries and members of the BSE. Initial and ongoing capital and other prudential requirements should be established for intermediaries and members of the BSE. These requirements should be

phased-in as actions are taken to increase activity occurring in Azerbaijan’s capital markets, and as markets themselves grow.

**Constraint Analysis:** High levels of public confidence in the integrity and capitalization of the exchange and its members is essential. Although regulators can be expected to prevent the financial failure of market intermediaries, regulation should aim to reduce risk of failure (including through capital and internal control requirements).<sup>10</sup> These requirements should take into account the risks that intermediaries and stock exchange members undertake.

**Prioritized Recommendation:** Establish and phase-in capital requirements on intermediaries and stock exchange members<sup>11</sup>.

- Initial and on-going capital requirements should be designed to achieve an environment in which an intermediary and stock exchange member can meet the current demands of their counter parties and, if necessary, wind down without loss to their customers.

**Benefit to Capital Market Development:** Increased confidence in the financial soundness of intermediaries and members of the BSE will allay investor concerns and encourage activity on the BSE.

### **Managerial Accountability and Financial Reporting Practices**

**Current Status:** Currently only issuers of securities listed on the first tier “quoted” level of the BSE are required to file financial statements in accordance with International Financial Reporting Standards (IFRS)<sup>12</sup> and International Audit Standards (IAS).<sup>13</sup>

**Constraint Analysis:** International principles of best practice require that accounting and auditing standards for public offerings should be of a high and internationally accepted quality.<sup>14</sup> Azeri National Accounting standards fall short of these requirements and are not sufficient to generate the knowledge and confidence required to increase financial intermediation on the exchange.

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<sup>10</sup> See IOSCO Public Document No.80, “Causes , Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets – Interim Report”, IOSCO Emerging Markets Committee, September 1998, and IOSCO Public Document No. 99, “Causes , Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets, IOSCO Emerging Markets Committee, November 1999.

<sup>11</sup> For guidance, see report of IOSCO Emerging Markets Committee on “Guidance to Emerging Market Regulators on Capital Adequacy Requirements for Financial Intermediaries” dated December 2006, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD230.pdf>

<sup>12</sup> International Financial Reporting Standards (IFRS) are standards and comments accepted by the International Standards Council on Accounting (ISCA).

<sup>13</sup> International Audit Standards (IAS) are International Audit Standards approved by the International Council on Audit and Approved Standards and are to be used by auditors in their report on the financial operations of an enterprise.

<sup>14</sup> See IOSCO Principles for Issuers.

**Prioritized Recommendation:** Strengthen managerial accountability and financial reporting practices. IFRS and IAS should be required for all firms listed on the tier one and tier two “quoted” levels of the BSE, and for all companies participating in secondary markets issuances. At a minimum, these requirements should be phased-in when practicable over the medium-term.

**Benefit to Capital Market Development:** Heightened quality of financial reporting by companies listed on the quoted tiers of the BSE and for all companies participating in secondary markets issuances will better ensure protection of investors’ rights, increase investor confidence and, in turn, contribute to increased activity on the BSE.

### **Governance of Capital Market institutions**

**Current Status:** Governance provisions, standards and practices of Azerbaijan’s financial market institutions and its market intermediaries fall short of international standards. There are currently no SROs<sup>15</sup> that are functioning as such in the securities market in Azerbaijan.

**Constraint Analysis:** The institution of SROs (which can be a valuable complement to regulatory efforts of the SCS to ensure Azeri financial market institutions and their membership are governed by principles of ethical conduct<sup>16</sup> that are consistent with the objectives of protecting investors’ rights and ensuring that Azeri markets are fair, efficient and transparent) is underdeveloped in Azerbaijan. Confidence in the reliability of Azerbaijan’s capital market hinges on public confidence in the integrity of its capital market institutions, including intermediaries, the stock exchange, depositories, etc.

**Prioritized Recommendation:** Ensure that all capital market institutions (intermediaries, exchange, depositories, etc.) adopt governance standards that are consistent with international best practice. To accomplish this:

- SCS should consider recognizing/authorizing<sup>17</sup> BSE to act as an SRO and impose upon it the responsibility to regulate its members. As such, the BSE/SRO should be required to :
  - Adopt regulations that ensure that all members and applicants for membership are treated in a fair and consistent manner.

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<sup>15</sup> Article 1078-41 of the Civil Code provides for establishment of “Organizations Regulating Professional Participants of Securities Market.”

<sup>16</sup> SROs may require observance of ethical standards which go beyond government regulations.

<sup>17</sup> As a condition to authorization, SCS should require BSE (and any SRO) to:

- have the capacity to carry out the purposes of the laws and regulations on SROs and to enforce compliance by its members and associated persons,
- develop and submit for approval rules designed to set standards of behavior for its members and promote investor protection,
- cooperate with SCS and other SROs to investigate and enforce applicable laws and regulations,
- enforce its own rules and impose sanctions,
- assure fair representation of its members in selection of directors and administration,
- avoid rules that create uncompetitive situations, and
- avoid using the oversight rule to allow any market participant unfairly to gain advantage in the market.

- Adopt a Code of Ethics<sup>18</sup> to govern the activities and behavior by its members that includes ethic principles of:
  - Integrity and fairness
  - Promise keeping
  - Loyalty – Managing and fully disclosing conflicts of interest
  - Fairness to the customer
  - Doing no harm to the customer or the profession
  - Maintaining Confidentiality
- Support efforts by the SCS to regulate the conduct of intermediaries and with consent of the SCS monitor compliance by its members with standard books and records requirements established by the SCS.
- With consent of the SCS, assume front-line responsibility for monitoring compliance by its members with phased-in capital requirements (see above, “Establish and Phase-In Capital Requirements for Intermediaries and Stock Exchange Members”).
- Alternatively, SCS should meet with representatives of BSE and recently formed “Association of Participants of Azerbaijani Stock Market,” of which the BSE is a member, and rationalize an appropriate role for the Association to play whether as an SRO or as an industry association. In any event, the Association should be responsible for:
  - Regulations that ensure all members and applicants for membership are treated in a fair and consistent manner
  - Adoption of rules of ethical conduct for its members
  - Monitoring the conduct of its members
- Depending on the course SCS determines to pursue, SCS should also consider requiring all licensed securities market participants to be members of the (securities industry) SRO or association.

**Benefit to Capital Market Development:** Confidence in Azerbaijan’s capital market institutions will improve when its major institutions and intermediaries demonstrate transparent governance practices that are designed to protect investors’ rights and ensure that markets are fair, efficient and transparent.

### **Corporate Finance**

**Current Status:** The legislative infrastructure supporting corporate finance needs improvement. The current legislative structure for corporate finance is inadequately developed.

**Constraint Analysis:** The process of financial intermediation outside the exchange is currently constrained by the lack of sound private placement law and regulation.

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<sup>18</sup> For guidance, see report of IOSCO SRO Consultative Committee on “Model Code of Ethics” dated June 2006, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD217.pdf>

**Prioritized Recommendation:** Streamline and clarify the legal framework for private placements.<sup>19</sup> Private placements are permitted under the civil code, but that process is almost entirely undeveloped and undefined in the regulatory framework. Joint stock companies financed through a private placement process might then provide a more fertile breeding ground for open joint stock companies that could truly benefit from the financial intermediation a national exchange could offer.

**Benefit to Capital Market Development:** Transparent and effectively regulated securities markets are efficient markets. The financing needed to support the growth of existing and future Azeri enterprises will prove far more accessible when the existing legislative/regulatory framework for private placements is overhauled to better facilitate access to non-bank financing for growing Azeri enterprises.

### **Trading of Securities by Non-licensed Parties**

**Current Status:** Currently individuals are allowed to trade securities directly among themselves; additionally, if such a transaction is not concluded by a broker or one of the parties is not a dealer, the parties are allowed to conclude the transaction through a notary.<sup>20</sup>

**Constraint Analysis:** Individuals that trade securities among themselves are not required to submit the transaction information to the registry, depository or central securities lien registry on a timely basis; the same constraint exists for trades transacted through notaries. As a result, registry, depository and lien registry records do not contain comprehensively accurate ownership records.

### **Prioritized Recommendation:**

- Rationalize and modify off-exchange trading privileges such that all notary and private-party transacted trades clear and settle ‘next day’ with full price reporting required for all ‘off-exchange’ trades.
- Require all off-exchange trades to be settled through the securities market’s clearance and settlement system. Following settlement, safe-keep settled securities at central securities depository.

**Benefit to Capital Market Development:** A modern capital market can begin to operate in Azerbaijan only after the central securities depository and central lien registry are known to contain accurate and timely securities ownership data. This condition can only be achieved when the data for all securities trades are channeled on a very timely basis through these central ownership databases.

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<sup>19</sup> In accordance with Civil Code Article 1078-20.8, transactions for distributed shares of joint stock companies with more than 100 shareholders are required to be concluded through the stock exchange.

<sup>20</sup> In accordance with Civil Code Article 1078-20.7.

## **Company Reporting Requirements**

**Current Status:** While public reporting companies (OJSCs) are required to file annual periodic reports and information on events having substantial impact on their financial and economic activities with the SCS, and there are provisions for publication in mass media after approval by the SCS, the law does not provide an effective mechanism<sup>21</sup> for the SCS to force observance of the disclosure requirements.

**Constraint Analysis:** As a consequence, many public companies are failing to abide by the disclosure requirements and the SCS is placed in the position of being perceived as an effective regulator.

**Prioritized Recommendation:** In context of the recommendations discussed above to strengthen and enforce investors' rights (see above, "Shareholder Rights"), rationalize the disclosure requirements for public companies to reduce the current large number of companies required to file annual reports with the SCS without demonstrable impact on potentially affected shareholders.

**Benefit to Capital Market Development:** Maximizing SCS efforts to protect investors' rights through more efficient and effective use of staff resources accompanied by a positive reduction in the number of companies required to comply with on-going disclosure requirements will serve to enhance investor confidence in the SCS as a regulator and in the Azeri securities market.

## **Financial Analytical Capacity at SCS**

**Current Status:** At present the staff of the SCS lacks the financial analytical capacity to effectively analyze the financial and other reports filed by Open Joint Stock Companies (OJSC) whose securities are located on the exchange.

**Constraint Analysis:** Without the requisite financial analytical capacity of its staff to analyze the financial reports filed by OJSCs, the SCS is unable to effectively protect investors' rights.

**Prioritized Recommendation:** Improve financial analytical capacity at the SCS in the near-term, then deploy that new capacity monitoring and analyzing reporting from Open Joint Stock Companies whose securities are located on the exchange. To accomplish this leverage upon the knowledge and the resource capabilities of the Ministry of Finance Accounting Department to support development of the financial analytical and other accounting skills which are required within the SCS (see below, "Strengthen Accounting Linkages with the Ministry of Finance").

**Benefit to Capital Market Development:** Increased financial analytical capacity at the SCS will enable the SCS to better protect investors' rights and will serve to both enhance

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<sup>21</sup> According to Articles 206 and 214 of the Code of Administrative Offences, the SCS may impose administrative sanctions for violation of the disclosure requirements.

the perception of the SCS as an effective regulator and investor confidence which, in turn, will attract investors to companies whose shares are located on the exchange.

### **Regulation of Collective Investment Schemes (CIS)**<sup>22</sup>

**Current Status:** As discussed below (see “Collective Investment Schemes”), while the legal framework nominally allows for CIS, there are currently no CIS operating in Azerbaijan. To jump-start the establishment of CIS, the current legal framework needs to be substantially improved or replaced and the staff of the SCS and licensed securities market participants will need to be trained. Important, too, the investing public will need to be made aware of the value of CIS to them and the enhanced capacity of the SCS to regulate CIS.

**Constraint Analysis:** Lack of available collective investment products in which the public can invest restricts the growth of Azerbaijan’s capital markets. Lack of collective investment products to regulate limit the capacity of the SCS to improve their skills. Lack of collective investment products deny the opportunity for citizens of Azerbaijan to invest in a secure form of savings appropriate for retirement planning, educational savings, medical emergencies, and similar purposes.

**Prioritized Recommendation:** Once the current legal framework for CIS is substantially improved or replaced, strengthen the capacity of staff at the SCS to regulate CIS, particularly initial issuance and supervision/regulation of usual trouble spots such as valuation, rights of redemption and custody verification of assets. To accomplish this leverage upon the recommendations and areas for attention which are described below, see “Collective Investment Schemes (CIS).”

**Benefit to Capital Market Development:** Increased liquidity and availability of fresh capital for investment in Azerbaijani companies whose securities are traded on the stock exchange. New financial products that provide an opportunity for citizens of Azerbaijan to invest in a secure form of savings appropriate for retirement planning, educational savings, medical emergencies, etc.

## **(3) STRENGTHEN THE SUPPLY OF FINANCIAL PRODUCTS**

### **Expand Inter-bank Trading of Government Securities and Public Investment in Government Securities**

**Current Status:** The inter-bank market for National Bank Notes and Ministry of Finance T-bills is currently not liquid. Banks are constrained from conducting sufficient desired levels of inter-bank government securities trading as a result of a variety of factors (see above, “ Commercial Bank/Central Bank Access to Government Securities Market”), and domestic private investment in the government securities market is limited.

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<sup>22</sup> For guidance on regulation, operation and governance of CIS, see the reports of IOSCO Emerging Market Committee and Technical Committee mentioned in Appendix C.

**Constraint Analysis:** Banks are required to conduct all secondary market trades through non-bank securities market intermediaries. Clearance and settlement is not automated, and the clearance and settlement operations are not integrated with the central bank's AZIPS, so clearance and settlement is time consuming and subject to uncertainties. Capacity of banks to replace T-Bills sold or lend to others is constrained by both an uncertain T-Bill auction schedule and subsequent difficult-to-predict results announcements.

**Prioritized Recommendation:**

- Remove market friction by opening up direct participation in primary and secondary market trading of government securities to all licensed commercial banks and the central bank – i.e., remove the requirement that banks trade government securities through licensed brokers or dealers.
- Increase volume of primary issuances by the Ministry of Finance, in all maturity ranges.
- Strengthen demand for Government of Azerbaijan T-Bills by providing support to Ministry of Finance to help them move toward best practices in government debt issuance, in particular emphasizing issuance planning, issuance practices, and yield curve development aimed at creating a more reliable primary market to attract a broader base of investors in Azerbaijan government securities.
- Expand volume of secondary market interbank trading in government securities by:
  - Shortening settlement time through linking the AZIPS to the BSE and the depository,
  - Redesigning government securities clearance and settlement processes, then
  - Automating the clearance and settlement of government securities.
- Launch a public awareness campaign to educate the public in the benefits of investing in Government of Azerbaijan government securities.

**Benefit to Capital Market Development:** Active corporate bond markets, typically building blocks to corporate equities markets, generally materialize only after a reasonably liquid government securities market begins to operate in a nation's capital market.

**Collective Investment Schemes (CIS)**

**Current Status:** Azerbaijan's current legal framework nominally allows for collective investment schemes, but the legal framework needs to be substantially improved or replaced. Regulatory staffs are unschooled, in CIS and untrained / inexperienced in regulating CIS. Investment managers, brokers and dealers are not sufficiently familiar with Collective Investment Schemes. The investing public is insufficiently aware of the existence of value of collective investment schemes, and unaware of the SCS' capacity to regulate CIS.

**Constraint Analysis:** Lack of available collective investment products in which the public can invest restricts the growth of Azerbaijan's capital markets. Lack of collective investment products to regulate limit the capacity of the SCS to improve their skills. Lack of collective investment products deny the opportunity for citizens of Azerbaijan to invest

in a secure form of savings appropriate for retirement planning, educational savings, medical emergencies, and similar purposes.

**Prioritized Recommendation:**

- SCS staff receives assistance and support in reviewing, substantially revising and completing or replacing the existing skeletal legal and regulatory framework governing CIS<sup>23</sup>.
- SCS staff receives extensive training in the supervision and regulation of CIS, with particular emphasis on regulation of asset valuation, CIS reporting to regulators and investors, and enforcing best-practice custodial regulations.
- Areas for attention in revising and completing or replacing the skeletal regulatory framework governing CIS include:
  - Currently, the CIS offering document is not required to include information on:
    - Any pending legal proceedings involving the CIS;
    - Procedures for purchase, redemption and pricing of units;
    - Risks involved in achieving the CIS’s investment objectives;
    - SCS’, auditor’s or depository’s responsibilities in relation to the CIS; or
    - Methodology used for asset evaluation.
  - While there are specific standards or requirements for operation of a CIS<sup>24</sup>, there are no specific standards or requirements for eligibility to promote or sell a CIS, nor are there “fitness” (honesty/integrity) standards for operators of CIS.
  - While the head of a CIS is required to be licensed as an investment manager<sup>25</sup>, there are no standards or requirements to gauge the capacity of the operator to discharge operator-specific powers and duties nor the judge the adequacy of internal management procedures.
  - There are no continuing professional training requirements for operators of CIS (licensed investment managers).
  - It is not clear that the CIS’ independent auditor is required to report to the SCS any irregularities or areas of non-compliance which are revealed in the course of audit.
  - Although CIS operators are subject to a general and continuing obligation to report to the regulator and investors any material changes in its management or organization<sup>26</sup>, the SCS’ approval of these changes is not required.
  - While Article 25.3 of the Law on Investment Funds requires that investment funds are to inform the SCS within 30 days of a material change in the agreement with the management, depository and registrar of the investment

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<sup>23</sup> For guidance on regulation, operation and governance of CIS, see reports of IOSCO Emerging Market Committee and Technical Committee mentioned in Appendix C.

<sup>24</sup> Article 25 of the Law on Investment Funds

<sup>25</sup> Article 21.5 of the Additional Licensing Rules

<sup>26</sup> Under Article 25.3 of the Law on Investment Funds, investment funds are to inform the SCS within 30 days of a material change in the agreement with the management, depository and registrar of the investment fund or their substitution.

fund or their substitution, there is no such provision with respect to a change in independent auditor.

- It is not clear that the operator of a CIS is required to separate and segregate CIS assets from the assets of managers, related entities and other schemes which it operates.
- It is not clear there are provisions in place to prohibit, restrict or disclose conduct likely to give rise of conflicts of interest between a CIS and its operator or their associates or related parties.
- Although the issuer of a CIS shall disclose events having a substantial impact on the financial and economic activity of a CIS<sup>27</sup>, there is no requirement that the offering document be kept to take into account any material changes affecting the CIS.
- Where as regulations on Evaluation of Assets of Open Investment Funds provide valuations of CIS shall be conducted on a quarterly basis<sup>28</sup> and methods for valuation of shares where market price is not available<sup>29</sup>, these regulations should be reconsidered in context of current market conditions.
- Investment Fund Reporting Rules<sup>30</sup> are not clear as to basis for regular disclosure or publication of the price of a CIS unit.
- Although the supervisory board of a CIS has the right to disclose (publish) annual reports on the managers' activity approved by the annual general meeting<sup>31</sup> there is no obligation to do so.
- There is no maximum time period prescribed for making payment of redemption proceeds.
- There are no rules governing the fees or charges payable by investors on purchase or redemption of shares or units in e CIS.
- There are no rules or mechanisms to address errors in respect to the price of a CIS share or unit, or the value of CIS assets.
- It is not clear that the SCS has the right to demand, delay or stop the deferral or suspension of redemption rights.
- Investment managers, depositories and registrars together with other relevant professionals including Chamber of Auditors/auditors, brokers and dealers /members and staff of BSE receive training on the substantially revised or replaced legal framework for registration and operation of CIS.
- Investment Mangers, Brokers, Dealers, BSE and SCS work together to initiate the issuance of a Collective Investment Vehicle.
- A public awareness campaign is launched to educate the public in the benefits of investing in CIS.

**Benefit to Capital Market Development:** An active, successful CIS market will bring significant fresh investment capital into Azerbaijan's capital market, provide a lower-risk, more accessible channel through which the public can invest in Azerbaijan's capital

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<sup>27</sup> Article 1078-43.1.2 of the Civil Code

<sup>28</sup> Article 3.2.1

<sup>29</sup> Article 5.1.2

<sup>30</sup> Article 4.4

<sup>31</sup> Article 19.2.4 of the Law on Investment Funds

market, and provide a showcase to demonstrate the then newly developed regulatory capacity of the SCS.

### **Expand Corporate Securities Issues**

**Current Status:** Five or six of the better managed, more transparent and well capitalized firms traded in the BSE raised additional capital in the past year by re-issuing shares or issuing new corporate bonds. Most of these issues came from rapidly growing Azeri banks. Financial intermediation is occurring, according to existing securities and company law and current practices in the financial markets. However, there is significant room for improvement.

**Constraint Analysis:** Existing corporate issuances amount to little more than private placements to current existing shareholders and investors. Outdated and inefficient procedures in the capital market prevent the exchange and its associated institutions from adding significant value to this financial intermediation process, resulting in the exchange/depository serving as little more than a final stopping point for the issuer and investor to register the new shares or bonds. Since reporting of share/bond price data is not required by existing regulation, even the most basic data from the transactions are not made available to the investing public, preventing rational decisions about investment or resource re-allocations by investors.

#### **Prioritized Recommendation:**

- Thoroughly rewrite all existing private placement regulation and stock/bond market issuance procedures, distinguishing between private placements and stock/bond market issuances through the organized financial markets (BSE, Depository, etc.).
- Rationalize issuance procedures for both market segments (public offerings and private placements), bringing practices more in-line with international best practice.
- Banks, brokers and dealers work together to expand free-float in existing corporate stock and bond issues and expand public awareness of existing securities issues.
- Brokers and dealers work together to expand trading in those existing issues.
- Brokers and dealers create new high-quality corporate equity and bond issuances, such as:
  - senior debt issues from highly rated local banks,
  - preferred stock in well rated local banks,
  - securities backed by over-collateralized pools of seasoned mortgages,
  - asset-backed issuances of banks or leasing companies that feature a partial guarantee from a highly rated, credible guarantor.

**Benefit to Capital Market Development:** Improving the regulatory framework for the private placement market will facilitate financial intermediation through the financial markets outside the BSE universe of approximately 35 large companies. Increased financial intermediation to this second tier of Azeri enterprises will create a more fertile breeding ground for growing firms that may then later develop financial needs better addressed by an organized financial exchange. Expanding the float in existing issues,

creating new low-risk securities and expanding public awareness of those securities will help to expand demand for investible securities traded in the organized capital market.

#### **(4) COMPREHENSIVE TACTICAL REORGANIZATIONS WITHIN THE STATE COMMITTEE FOR SECURITIES**

##### **Establish Public Relations Function within Administration Department**

**Current Status:** At present there is no public relations function within the SCS.

**Constraint Analysis:** The public (and particularly investors), issuers and licensed securities market participants need to be aware of the programs and activities of the SCS.

**Prioritized Recommendation:** Under the existing Administration Department, ensure that ‘Secretariat-type’ functions are addressed, including: public relations, a spokesperson for the SCS, management of international relations, a secretary that provides public notice of meetings and minutes of meetings, etc.

**Benefit to Capital Market Development:** Awareness of programs and activities of the SCS that are designed to protect investors; ensure the markets are fair, efficient and transparent; and reduce systemic risk will engender investor confidence and foster increased activity in the securities market.

##### **Establish Department for Protection of Investors’ Rights**

**Current Status:** At present there is no Department for Protection of Investors’ Rights within the SCS.

**Constraint Analysis:** A Department for Protection of Investors’ Rights is vitally needed to address and allay investor concerns, assure investors that their rights and interests are being protected, and ensure a sense of confidence among investors in investing in Azeri public (open joint stock) companies.

**Prioritized Recommendation:** Establish a Department for Protection of Investors’ Rights to ensure increased monitoring and enforcement of corporate governance provisions of issuer communications, periodic reports, shareholder voting information, tender offers, collective investment instruments, etc.

**Benefit to Capital Market Development:** Increased awareness and confidence among investors that the SCS is focused on addressing and protecting their rights will lead to increased investment activity.

## **Streamline Market Regulation**

**Current Status:** At present the regulation and supervision of licensed securities market participants (i.e., brokers and dealers, exchanges, clearing facilities, depositories, registries, etc.) appears to be spread across the Turnover Regulation Department and Licensing and Supervision Department.

**Constraint Analysis:** A heightened level of efficiency could be obtained by streamlining the responsibilities of the Turnover Regulation Department and Licensing and Supervision Department to reduce the possibility for overlap and more effectively monitor and regulate the activities of licensed securities market participants.

**Prioritized Recommendation:** Streamline and harmonize the responsibilities, processes and procedures of the Turnover Regulation Department and Licensing and Supervision Department such as to prevent functional and procedural gaps and overlaps and ensure greater overall operational efficiency and effectiveness in regulating and supervising licensed market participants. The objective is to establish and maintain (through processes and procedures established by SCS) standards conducive to fair, orderly, efficient and safe markets, primarily through the supervision and regulation of licensed securities market participants. In the medium term, to achieve greater economies of scale, we also recommend the SCS considers combining the current Turnover Regulation Department and Licensing and Supervision Department and establishing a consolidated “Market Regulation Department.”

Commensurate with the above:

- The functions and responsibilities of the respective departments should be clearly defined.
- To ensure efficiency and regulatory effectiveness, there should be a clear inter-department protocol which describes and ensures full and proper coordination of efforts between the respective departments, and especially in keys areas such as market surveillance and on-site inspections.
- To avoid the dilution of efforts and ensure focused development of the specialized surveillance and inspection oversight capacity that will be required, any non-securities related regulatory functions should be moved outside of the respective departments and especially the Licensing and Supervision Department.
- Based of the functions and responsibilities of the respective department, initial and on-going responsibilities should include reviewing and recommending proposed changes and improvements to existing or additional regulations and procedures pertaining to the responsibilities of the respective department including:<sup>32</sup>
  - Minimum entry standards for licensed securities market participants.
  - Procedures for receiving applications, filing them, and assigning applications to staff for review. Procedures should also be established for supervision of this process, as well as issuance and publication of licenses.
  - An inspection program to conduct regular and special inspections of all licensed entities. An inspection manual and set of inspection procedures

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<sup>32</sup> For guidance, see IOSCO “Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation” found at <http://www.iosco.org/library/>

will need to be established. The goal is to detect regulatory problems before they occur.

- A program/set of procedures for the supervision of exchanges and organized public markets. The department should be responsible for licensing and inspecting these entities, and for reviewing and approving rules, organization and listing requirements for these entities.
  - Assigning filings to staff and reviewing, granting and revoking licenses; reviewing reports submitted by market participants (within a reasonable timeframe based on objective standards). Systems should be established to accomplish these goals and to enable department staff to access reports and market data promptly and review them on an analytic basis.
  - A procedure to refer matters that appear to be a violation of law which the department discovers in its inspection program, through market surveillance or other sources.
  - A program/set of procedures to maintain awareness of the market and make recommendations for policy changes (i.e., as the Azeri capital market develops, the department will need to remain ready to make recommendations for change, such as, introducing regulations on short selling and margin rules.
  - A program/set of procedures to ensure that SROs (when duly recognized) are actually regulating their own membership.
  - A surveillance program/set of procedures to assure that the stock exchange monitors trading and informs the SCS in the event trading patterns suggest/indicate a violation of the law.
- Based on the above and other activities that are identified to ensure against regulatory gaps and overlaps, job functions and responsibilities should be rationalized and job descriptions established for the supervisors and staff of each department.
  - Thereafter, supervisory and staff capabilities should be assessed and supervisors and staff designated for all functions and responsibilities.
  - During the process of designating supervisors and staff within each department, initial training needs should be assessed and provisions made to meet training needs.
  - Supervisors and staff within each department will need an understanding of international markets and an in-depth understanding of the operations of the stock exchange, clearance facility, depositories and other licensed securities market participants.
  - Supervisors and staff within the respective department (if not both departments) will need to be trained in inspection and surveillance techniques, and in methods to analyze and detect problems of market participants.
  - Licensed securities market participants should be familiarized with the role and responsibilities of each of the respective departments and should be made aware of their obligations including those to cooperate with and to comply with all appropriate requests from both the departments.
  - When deemed appropriate, under responsibility of the appropriate department, consider devolving certain monitoring, compliance and reporting responsibilities to

the BSE (see below, “Devolve Certain Responsibilities to the BSE and Broker-Dealer Community”).

**Benefit to Capital Market Development:** More effective monitoring and regulation of the activities of licensed securities market participants and institutions will serve to ensure the integrity of licensed market participants and institutions, reduce systemic risk, and encourage the formation of capital.

### **Aggregate Enforcement Responsibility**

**Current Status:** At present “enforcement” responsibilities appear to be spread across several departments within the SCS including the Legal Department and Licensing and Supervision Department, and there is no one department or specialized division within one department of the SCS which has exclusive responsibility for activities related to enforcement of the legal and regulatory framework that comprise the securities laws and ensure the protection of investors’ rights in Azerbaijan.

**Constraint Analysis:** To aggregate enforcement responsibilities within one department or within a division of one department (preferably the Legal Department) of the SCS would result in less administrative fragmentation and greater efficiency and enable the SCS to focus more specialized attention and resources on enforcement of the securities laws and the protection of investors’ rights.

**Prioritized Recommendation:** Establish a separate department or specialized division within one department (we recommended the Legal Department) of the SCS which has exclusive responsibility for enforcement activities including review of complaints, formal and informal investigations, the conduct of administrative proceedings and revocation and suspension proceedings, and the review of cases to be referred under criminal provisions against individuals and entities. The separate department or division of the Legal Department should also be responsible for requests for confidential treatment and access to SCS files relating to enforcement matters. While it appears that the range of activities for which the proposed separate department or division of the Legal Department should be responsible are currently covered in large part between the Legal Department and Licensing and Supervision Department, we believe that the benefits to be derived from establishing a separate department or division within the Legal Department which has exclusive responsibility for enforcement activities should be realized going-forward and, if practicable, within the near-term.

**Benefit to Capital Market Development:** More effective enforcement of the securities laws will serve to ensure the protection of investors’ rights and the integrity of the capital market.

## **Devolve Certain Responsibilities to the BSE and Broker-Dealer Community**

**Current Status:** While current legislation provides for self-regulatory organizations of professional participants of the securities market (SROs),<sup>33</sup> and the BSE has in large part assumed the responsibilities placed upon it under the Civil Code,<sup>34</sup> there is more that the BSE (and its membership) could be encouraged and empowered do as a SRO to fulfill its statutory purpose to protect the interests of investors. In this regard, the recently formed “Association of Participants of Azerbaijani Stock Market,” of which the BSE is a member, could also be considered to play an appropriate role in devolvement of some of these functions to the broker-dealer community, and as an SRO or securities industry association

**Constraint Analysis:** The regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate with the size and complexity of the markets.

**Prioritized Recommendation:** Gradually, over the long-term, devolve some of the functions of the current Analysis and Market Department (e.g., performing economic and trend analyzes of activities in the securities markets) from the SCS to the BSE and the broker-dealer community (also see “Governance of Capital Market Institutions”).<sup>35</sup> Activities that could also be devolved to the BSE as a SRO include:

- Monitoring of compliance with standard books and records requirements established by the SCS for its members.
- Front-line monitoring of compliance with phased-in capital requirements for its members (see above, “Establish and Phase-In Capital Requirements for Intermediaries and Stock Exchange Members”)
- At direction of SCS, adoption of a Code of Ethics for brokers and dealers and exchange members trading on the BSE.<sup>36</sup>

Alternatively, the recently formed “Association of Participants of Azerbaijani Stock Market,” of which the BSE is a member, could also be considered to play an appropriate role in devolving some of the functions of the current Analysis and Market Department, and as an SRO or securities industry association.

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<sup>33</sup> According to Article 1078-41 of the Civil Code, an organization regulating professional participants of the securities market has the purpose of protecting the interests of investors and other participants of the securities market and to develop ethical norms for its members and enforce them (Article 1078-41.2 of the Civil Code).

<sup>34</sup> Pursuant to Article 1078-39 of the Civil Code, the BSE has responsibility to establish rules on trading with securities and provide for sanctions for violation of the rules including monetary sanctions.

<sup>35</sup> Under the IOSCO “Principles for Self-Regulation,” the regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.

<sup>36</sup> For guidance, see report of IOSCO SRO Consultative Committee on “Model Code of Ethics” dated June 2006, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD217.pdf>

**Benefit to Capital Market Development:** Ethical practices and reduced of risk ensure a heightened sense of confidence among investors in the securities market and its institutions that leads to increased investment activity.

### **Strengthen Accounting Linkages with the Ministry of Finance**

**Current Status:** Beginning from January 1, 2008, companies having their securities circulated at the stock exchange and companies having annual income of at least 30 million AZN are required to maintain financial accounts in accordance with IFRS. Also beginning from January I, 2008, the accounting standard for all (other) commercial entities became the “National Accounting Standard for Commercial Entities” which accords with International Accounting Standard No. 1 titled “Presentation of Financial Statements.”

**Constraint Analysis:** While the Ministry of Finance is the regulatory oversight body which sets the standards for accounting in Azerbaijan, all public (open joint stock) companies are required to file their annual financial reports with the SCS

**Prioritized Recommendation:** Strengthen institutional linkages between accountants within the SCS and the accounting standards and accounting enforcement personnel at the Ministry of Finance. Recommended steps to be taken include:

- Establishment of regular “collegial” meetings between accounts and accounting enforcement personnel from the Ministry of Finance and SCS:
  - Among first efforts should be to establish a series of “informal” training initiatives wherein the accounting and auditing standards (IFRS, IAS, Azeri National, etc.) are presented and discussed by staff from the Ministry of Finance.
  - Thereafter the Ministry of Finance’s accounting enforcement programs should be presented and discussed by accounting enforcement personnel from the Ministry of Finance.
  - In the context of these discussions, from the standpoint of the SCS’ regulatory responsibilities, SCS accounts should fully acquaint their colleagues from the Ministry of Finance the financial reporting requirements that they are charged to administer for the protection of investors’ rights.
  - During the exchange process synergies should be identified and as an outcome cooperative undertakings should be reached to work together to ensure compliance with the financial reporting requirements for public reporting companies and, in particular, those companies whose shares are offered on the exchange (and, once established by regulation, those companies that seek to make an exempted “private placement” of securities, etc.).
- Establishment of an inter-agency “working group” co-chaired by representatives from each of the Ministry of Finance and SCS. The objective of the working group would be to identify interventions and initiate activities designed to improve compliance will financial reporting by public reporting companies in Azerbaijan and, in particular those whose securities are traded of the exchange..

- Under auspices of the Ministry of Finance and SCS, the working group should consider conducting “roundtable discussions” and “workshops” involving representatives of the Chamber of Auditors and practicing accounting and auditing communities, as well as from the stock exchange and broker-dealer communities. The objective is to unite those participating in an effort to improve compliance with applicable international and national standards and raise the quality of financial reporting and ensure greater protection of investors’ rights.
- The above activities should also involve participation by staff from the new Department for Protection of Investors’ Rights (see above “Establish Department for Protection of Investors’ Rights”). The objective being to better equip them with the accounting knowledge and analytical skills required to perform their important work to protect investors’ rights.
- From time to time staff from the Public Relations function (see above, “Establish Public Relations Function within the Administration Department”) should be invited to participate in the above activities and should be responsible to broadly disseminate information concerning these activities and their objectives to the public.

**Benefit to Capital Market Development:** Full and meaningful disclosure of financial and other information material to investors’ decisions is the most important means for ensuring investor protection.

**LIST OF PERSONS INTERVIEWED**

**Baker & McKenzie**

Daniel R. Matthews, Director  
Abbas Guliyev, Associate

**Baku Stock Exchange**

Khayal Abdinov, Chairman of the Board  
Vugar Namazov, Head of Trading Department

**National Depository Center**

Bakhtiyar Aziziv, President  
Namiq R. Mahmudzade, Vice President  
Nigar Mammadova, Head of Legal and International Relations Department  
Elsevar Khalilov, Head of Department  
Rashid Salifov, Head of Department

**Standard Capital, Rustam Ibrahimov, Head Securities Sales Specialist**

**State Committee for Securities of the Republic of Azerbaijan**

Rufat J. Aslanly, Chairman  
Mehman A. Abbas, Head of Administration  
Jomard Aliyev, Head of Department  
Kamaran Babayev, Head of Legal Department  
Leyla Mamuscadova, Legal Department  
Elnur Allahverdiyev, Head of Department of Issues and Registration  
Tural Khan, Advisor, Department of Issues and Registration  
Madaim Rahimi, Head of Licensing and Regulation Section, Department of  
Market Infrastructure  
Rasim Safarov, Head of Securities Operation Division, Department of Market  
Infrastructure  
Aghahuseyn Khudaverdiyev, Head of Division  
Anar Ahmadov, Head of Registration of Lien on Securities Division

**State Oil Fund of the Republic of Azerbaijan**

Shahmar Movsumov, Executive Director  
Israfil Mammadov, Chief Investment Officer

**Azerbaijan Mortgage Fund under the National Bank of Azerbaijan**

Rahman Hummatov, Deputy Executive Director  
Ilham Kalashov, Head of Legal Department  
Mustafa Mammadov, Head of Strategic Planning and Development Group

Baku Interbank Currency Exchange  
Zahid Mammadov, Consultant  
Aynur Bayramli, Head of International Relations Department

National Bank of Azerbaijan (Central Bank)  
Isi Mustafayev, Head of Market operations Division

**LIST OF DOCUMENTS REVIEWED<sup>37</sup>**

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Farhad Amirbekov, “Development of Exchange Business [sic] In Azerbaijan: New Impulse of Regional Integration, Baku Interbank Currency Exchange, published in *Banks & Business*, Special Issue (17 April 2008).

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Ramil Isgandarov, “A Guide to the Republic of Azerbaijan Law Research,” (September 2006) available at [www.Globallex.com](http://www.Globallex.com).

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<sup>37</sup> All of the documents listed in this Appendix(except those with an asterisk (\*)) are available without charge at the specific Internet web sites indicated, or on the Internet by doing a Google search of the title.

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\*Information on securities market, developed by SCS for the USAID mission that would visit the Azerbaijan Republic in the month of January, 2009

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ZAO The National Depository Center of the Azerbaijan Republic website at <http://www.mdm.az/>

**RECOMMENDED IOSCO REPORTS ON COLLECTIVE  
INVESTMENT SCHEMES**

The following reports of the IOSCO<sup>38</sup> Emerging Market Committee and Technical Committee are recommended for guidance for when considering proposed changes and or amendments to the enabling legal and regulatory environment for CIS in Azerbaijan:

1. Report of the Technical Committee on Examination of Governance for Collective Investment Schemes, Final Report, Part II, February 2007, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD237.pdf>
2. Report of the Emerging Markets Committee on Collective Investment Schemes in Emerging Markets, July 2006, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD222.pdf>
3. Report of the Technical Committee on Examination of Governance for Collective Investment Schemes, Final Report, Part I, June 2006, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD219.pdf>
4. Report of the Technical Committee on Anti-Money Laundering Guidance for Collective Investment Schemes, Consultation Report, February 2005, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD188.pdf>
5. Report of Technical Committee on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds, Final Report, November 2004, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD178.pdf>
6. Report of Technical Committee on Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards, May 2004, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD169.pdf>
1. Report of Technical Committee on Investor Disclosure and Simplified Prospectuses by Collective Investment Schemes, July 2002, found at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD131.pdf>

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<sup>38</sup> Established in 1983, IOSCO is recognized as the international standard setter for securities markets. The Organization's wide membership of securities regulatory agencies regulates more than 90% of the world's securities markets and IOSCO is the world's most important international cooperative forum for securities regulatory agencies. IOSCO members regulate more than one hundred jurisdictions and the Organization's membership is steadily growing.