

Newsflash: Mongolia's New Strategic Foreign Investment Law - A Temporary Inconvenience?

On 17 May 2012 the Parliament of Mongolia enacted *the Law of Mongolia on the Regulation of Foreign Investment in Business Entities Operating in Sectors of Strategic Importance* (the "Strategic Foreign Investment Law" or the "SFI Law").

BACKGROUND

The enactment of the law comes at a tumultuous time of political posturing by Mongolia's political parties that are starting up campaigns for the general election to be held on 28 June 2012.

The developments stand in stark contrast to Mongolia's centuries-old reputation as a sleepy and quiet backwater. However, the country is undergoing profound change on account of its resource boom. Mongolia literally sits on mountains of coal, copper, gold, silver, iron, uranium and other essential metals eagerly sought by China to sustain its economic development. Next year, the Oyu Tolgoi copper mine will enter into production, thus providing the government with a rich flow of royalties. The stakes could not be higher as ambitious Mongolians seek to be in power at the time of this bonanza. For many seekers of political office, the rhetoric of resource nationalism makes for an attractive campaign platform, as further evidenced by recent proposals to Parliament to increase the levels of taxation on companies in the mining sector, which is generally perceived as foreign dominated.

While Parliament first contemplated a similar draft law in 2009, the immediate catalyst for the reconsideration of the foreign investment regime appeared to be the proposed acquisition by state-owned Aluminium Corporation of China of Ivanhoe Mines' fifty-six per cent equity stake in South Gobi Sands LLC. At the time of the announcement, Mongolian law did not expressly impose any notification or approval requirements upon offshore transactions affecting strategic sectors of the economy.

This briefing is based upon the final form of the law presented to Parliament prior to its approval and enactment and a review of the final Plenary Session of Parliament (the "Plenary Session").

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Once the enacted form of the legislation is available, we will circulate an update of this briefing with details of any material changes.

KEY FEATURES

1. Strategic Importance

The SFI Law is underpinned by the concept of a "business entity of strategic importance" (a "BESI"). A BESI is any Mongolian company operating in one of three strategic sectors - minerals, banking and finance, and media and telecommunications. According to the SFI Law, these sectors are "strategically important for meeting the basic needs of the population, maintaining the independence and normal functioning of the economy, generating national revenue and ensuring national security".

These sectors are not specifically defined, and therefore the extent of the application of the law is unclear. The Plenary Session however confirmed that the "minerals sector" would include the oil and gas industry. It also is not clear whether the businesses providing services to these strategic sectors would be caught by the law, but given comments made in the Plenary Session, this appears unlikely.

The Plenary Session indicated that the list of strategic sectors may be amended by Parliament only on the basis of a recommendation from the Government.

2. Approvals for Non-State Foreign Investment

Pursuant to Article 6.1, the following transactions involving privately-owned foreign investors will require Government approval:

- The acquisition of, or the right to acquire 33 per cent or more of the shares in a BESI by a foreign investor;
- Where, as a result of a proposed acquisition of an interest in a BESI, regardless of the percentage of equity interest, a foreign investor has the right to:
 - solely appoint the executive management or a majority of the board;

- veto decisions of the executive management or board of directors; or
- determine or implement management decisions and/or operations;
- Where, as a result of a proposed acquisition involving a foreign investor, regardless of the percentage of equity interest, the transaction:
 - may potentially give rise to a monopoly (to either the seller or buyer) over mineral products on international or domestic commodity markets;
 - may directly or indirectly influence the market or the price of mineral products exported from Mongolia; or
 - may result in a potential reduction in the shareholding interest of a foreign investor.

The Government approvals referred to above apply to indirect offshore transactions.

3. Approvals for Foreign State Investments or Operations

Any acquisition or operations by a state-owned foreign investor or by an international organisation will require the approval of the Government. This applies regardless of whether the acquisition is made in a strategic sector or otherwise. The level of state ownership in the investor is irrelevant for these purposes. However, in respect of international organisations, this provision does not apply if Mongolia was a party to the international agreement by which the organisation in question was founded. For example, investments or operations by EBRD and IFC would be exempt.

4. Parliamentary Approval

Article 3.7 provides that the approval of Parliament will be required for any acquisition by a foreign investor of an interest in a BES I if such acquisition is of more than 49 per cent of the BES I's shares and the value of the acquisition exceeds 100 billion Mongolian tugrugs (approximately US\$76 million).

5. Tax

Any consideration paid by the foreign investor to the counterparty in relation to an acquisition of an interest of 33

per cent or more of a BES I will be subject to Mongolian tax, which must be collected through the BES I.

6. Procedure for Approval

The exact details of the approval procedure will be determined by the Government at a later date. However, the SFI Law does provide that a foreign investor wishing to enter into a transaction to which the law applies must first make a request for approval to the Foreign Investment Agency of Mongolia ("FIA"). Applications to FIA must be made by the BES I which is the subject of the investment. FIA will consider the following:

- Mongolian national security interests;
- the ability of the applicant to comply with Mongolian legislation and standard business practices;
- any anti-competitive or monopolistic consequences;
- any significant impact on the national budget or state policy; and
- any adverse impact on the strategic sector in which the investment is made.

FIA must submit its proposal to the Government on whether to grant approval within 45 days of receipt, and in turn the Government has 45 days to make a final decision on whether to approve the transaction. Within 5 days of the Government's decision, FIA must inform the applicant of the outcome.

7. Sanctions for Non-Compliance

The sanctions for non-compliance of the SFI Law set out in Article 9 are severe. Transactions concluded in violation of the requirements of the SFI Law shall be void, and the relevant authority regulating the offending BES I may terminate its operations or revoke any licences it holds. Corresponding amendments to the Minerals Law and Licensing Law were made by Parliament in order to enable the implementation of the sanctions in respect of revocation of licences.

8. Local Content

Article 3.8 of the SFI Law states that the Government will determine regulations which give preference to domestic business entities registered in Mongolia for the procurement of any goods and services to the strategic sectors. This provision appears to have application beyond transactions involving foreign investment, as it applies to all BESIs, whether or not they have been subject to a foreign investment event. In the Plenary Session, the definition of "domestic entity" for the purposes of clause 3.8 was extensively debated and was ultimately diluted to entities with greater than 50 per cent Mongolian ownership.

9. Notification Procedure

In the event a foreign investor acquires an interest in a BESI of between 5 and 33 per cent, the BESI must notify FIA within 30 calendar days of the acquisition.

A BESI in which a foreign investor held an interest of 5 per cent or above as at the date of enactment of the SFI Law must notify FIA within 180 calendar days of such date with the details of the foreign investor's holding.

10. Entry into Force

The SFI Law expressly states that it shall enter into force immediately, rather than 10 days from the date of Parliament's approval as would be customary.

POINTS OF CONCERN

There are a number of potential issues for foreign investors in relation to the application of the SFI Law, including the following:

- the drafting of the law is imprecise and unclear, which gives rise to a considerable amount of uncertainty for investors and a large margin of discretion for authorities;
- the approval process set out in the SFI Law creates uncertainty and is cumbersome, involving applications first to FIA and then to the Government, or in some cases, Parliament. This is likely to cause considerable delay and may result in a complete suspension of the approval process whilst Parliament is in recess. Further, the application of the law to all transactions entered into

by foreign state-owned enterprises, or by foreign investors in certain strategic sectors regardless of value, is likely to slow the process down even further;

- whilst the SFI Law as it is enacted does contain a monetary threshold for foreign investment in a BESI of over 49 per cent, it is not clear whether this threshold is calculated by reference to market value of shares, book value of assets or the value of the transaction;
- whilst the SFI Law is silent as to any retrospective application, the Plenary Session stated that there would be no retrospective effect. However, for foreign investors currently operating in Mongolia the law will apply, and therefore while existing positions will not have to be unpicked, any future transactions involving their equity investments would be subject to the law's provisions;
- the provisions relating to investment by state-owned companies or organisations are extremely restrictive, and have application regardless of the level of that interest or the sector in which the investment is made;
- the SFI Law provides that "if an international treaty to which Mongolia is a party is inconsistent with this law, then the provisions of the international treaty shall prevail". Mongolia has entered into bilateral investment and double taxation treaties with various countries, including China, Russia, the United Kingdom, the United States and the Netherlands, and has ratified the Energy Charter Treaty. These treaties generally accord "no less favourable" status to entities incorporated in such jurisdictions, and therefore it is not clear whether these entities would be excluded from the scope of the SFI Law. However, these treaties are often difficult to enforce and therefore the benefit of this provision for foreign investors is questionable. In any event, potential foreign investors need carefully to consider the legal ramifications of this provision.

CONCLUSION

Many long-term observers of Mongolia are hard pressed to disagree with the principle that is sought to be achieved under the SFI Law. As a land-locked country caught between two major superpowers, Mongolians are justifiably concerned about their national sovereignty and security.

Mongolia has a history of quickly introducing legislation and then repealing it or suspending its implementation when it has adversely affected the Mongolian economy. The so-called Windfall Profits Tax, which imposed a 68% tax on revenues derived from commodities, was enacted in 2006 and effectively repealed on 1 January 2011. The Law of Mongolia on the Prohibition of Mineral Exploration and Mining Activities in River Basins, Water Reservoir Areas, and Forested Areas, which seemed drastic when enacted in July 2009, is only now being implemented on a piecemeal and conservative basis.

Against this background, local commentators remain philosophical, as one put it – "before an election it's all about Mongolia, after the election it's all about the rest of the world". Mongolian politicians and the local business community, who to a large extent overlap, are not ignorant of the need for substantial foreign investment, indeed, their interests and those of foreign investors often align. The Parliament which rushed through the Strategic Foreign Investment Law is the same Parliament which has the power to rush through amending or repealing legislation, if it is so minded.

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For enquiries, please contact the following lawyers or those with whom you usually deal:

Michael Aldrich

Office Managing Partner, Ulaanbaatar
+976 7012 1020
michael.aldrich@hoganlovells.com

Chris Melville

Partner, Ulaanbaatar
+976 7012 8900 / +976 9999 7034
chris.melville@hoganlovells.com