Central Asia's new silk route – investment pathways to mineral profits

By John I. Huhs and James B. Varanese

This paper reports on significant changes in the legal regimes for mineral-sector investments in Kazakstan and Uzbekistan. It focuses specifically on the important changes underway in Kazakstan's legal regime for licensing mineral exploration and development rights, the approval of Kazak–Foreign joint ventures, privatizing Kazakstani mineral-sector enterprises and the rules generally applicable to foreign investment. The administrative law principles discussed are informative of the situation in Uzbekistan, as the two countries have similar legal-administrative regimes for mineral sector investments.

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Centuries ago, the famous Silk Route wound its way through Central Asia – a region now comprised of the six former Soviet Republics of Kazakstan, Uzbekistan, Kyrgyzstan, Turkmenistan, Tajikistan, and Azerbaijan – and traders of silk irrigated the region with foreign goods. Geologists explain that mineral deposits frequently cluster near unique geological structures that arise along fault lines in the Earth's crust. A truly wondrous fault line caused by the collision of the continental plates of Asia and Europe traverses Central Asia – like the Silk Route of centuries past – and investors in mineral rights now promise to irrigate the region with foreign capital.

Kazakstan and Uzbekistan are blessed with a disproportionate degree of rich mineral deposits. Interest from foreign investors is high due to the combination of mineral riches, inviting legal policies, and political stability. Just as was true of the Silk Route, which was in fact not one but many different alternative East-to-West routes, multiple investment pathways now guide foreign capital into Kazakstan's and Uzbekistan's mineral sector. These pathways lead foreign investors to profits from the exploration, mining, processing, and trading of valuable metals. In many ways these pathways all involve the "privatization" of mineral rights, which is the transfer of ownership or control from the State to private investors.

I. Basic legal principles for mineral investment

Three main organizing principles underpin Kazakstan's and Uzbekistan's legal regime for mineral rights:

(i) Initial exclusive State ownership of subsurface minerals may be transferred to the ownership of others only subsequent to their extraction to the surface;

(ii) A license for exploration, extraction, or a combination of these authorizes the licensee to extract minerals to the surface, and may be issued by the Ministry of Geology; and

(iii) A contract between the State and a third party transfers ownership of the mineral thus extracted, and may be concluded with the Cabinet Of Ministers ("Cabinet") or another agency delegated this authority by the Cabinet.

While these principles are not always explicitly stated in the applicable legislation, they are mirrored in Kazakstan's and Uzbekistan's compulsory license-and-contract scheme for mineral investments. The administration of this license-and-contract scheme is discussed in the following section.

II. Mining licences and joint ventures

The basis for mineral-sector investments in Kazakstan was established by the Kazakstan Parliament's adoption of *Law No. 1367a Code On The Subsurface And The Processing Of Mineral Raw Materials* (adopted May 30, 1992) (the "Mining Code"). The implementation of the Mining Code, related market economy reforms, and the privatization of the mineral sector, followed gradually.

The main legal reform in the area of mining licenses and joint ventures was initiated by President Nazerbayev in *Presidential Edict No. 1637 On Additional Measures For The Use Of The Subsoil* (adopted April 5, 1994). *Presidential Edict No. 1637* authorized and directed the Cabinet Of Ministers (in a legislative capacity, the "Cabinet" or, in a more general administrative capacity, the "Government") to issue regulations implementing mineral sector reforms. These legislative and regulatory initiatives have resulted in the following recent changes in Kazakstan's legal regime for licensing mineral rights and investing in joint ventures.

1. Re-organization of Kazakstan's regulatory regime for mining. As authorized by *Presidential Edict No. 1637*, the Cabinet issued *Cabinet Resolution 377* (adopted April 13, 1994), which effected the:

Some major enterprises in the Kazakian metals sector identified for CBC privatization in 1994 – 1995.

- Re-Drawing of the jurisdictional boundaries for the inter-Ministerial administration of Kazakstan's mineral-rights regime; as well as the
- Revising of the substantive rules for the entry of foreign capital.

Although the details of *Cabinet Resolution 377* need further refinement, and changes are expected as implementation confronts specific cases, the crucial regulatory changes are as follows.

Jurisdictional changes. Heretofore, the Ministry Of Geology And The Protection Of The Subsurface (the "MinGeo"), the Ministry of Industry, and various other agencies, exerted joint jurisdiction over mining exploration and development. Pursuant to Cabinet resolution No. 1637, all jurisdiction over the granting of legal rights to explore and extract minerals from the subsurface now is concentrated in the MinGeo.[1]

Moreover, to centralize the administration of licenses granted in the past, all mineral rights licensees are subject to the compulsory registration of such licenses by filing appropriate papers (original agreements in exchange for the issuance of a special deed) with the MinGeo; the penalty for non-registration may be revocation.

Substantive changes affecting foreign capital. The MinGeo is directed to – "as a rule" although exceptions may be considered – issue future licenses by international tender if foreign capital is involved. Moreover, henceforth all agreements between the foreign investor and its Kazak co-venturer are subject to approval by a unified "working committee" delegated this power by the Cabinet on a case-by-case basis. Both directives will make more transparent the process of awarding licenses. Surprisingly, however, the "bonus payment bypass" recently introduced by the Cabinet threatens to distort these new tender rules. The "bonus payment bypass" is a new procedure whereby the Cabinet may terminate an international tender already underway by awarding the license to a bidder who makes an immediate multimillion dollar "bonus" payment (similar to a non-refundable deposit).

Cautionary note. Foreign investors would be wise to determine at the outset whether their proposed Kazakstani co-venturer holds a registered license and

whether the proposed joint venture agreement has been reviewed and approved by the authorized Cabinet-appointed body.

2. New laws. The recent "constitutional crisis" in Kazakstan, in which the Kazakstan Parliament was disbanded and a new Constitution adopted, provided Kazakstan President Nazerbayev a window of opportunity to accelerate major legal reforms. President Nazerbayev's reforms have led to significant changes in Kazakstan's Cabinet and the legal basis for investments into the mineral sector.

One major example of President Nazerbayev's acceleration of reforms is Presidential Edict No. 2372 *On The State Regulation Of Precious Metals And Precious Stones* (adopted July 20, 1995) (the "Gold And Diamond Law"). Most importantly, the Gold And Diamond Law loosens the monopolistic grip of the National Bank Of Kazakstan ("NBK") on the purchase of gold. The central advantage of this de-monopolization is that foreign-owned producer may now directly export gold for sale, which facilitates financing the investment. Under the previous law, foreign investors found that banks were unwilling to lend for gold and other projects because there was no guaranteed right of export at world market prices, making gold exports hostage to the available hard-currency reserves of the NBK.

Another important legal development has not yet occurred: amendments to the Mining Code, which the Government publicly announced as a main priority. The current Mining Code was adopted in 1992, and in the view of many foreign investors requires a major re-working.

3. Exploration and development licenses. The MinGeo may issue or re-issue an exclusive: (a) exploration license, (b) development (that is, extraction, production, and processing) license, or (c) *combination* exploration-development license. The exploration license is exclusive to a particular territory (with a negotiated renouncement of territory over time). The development license customarily is ineffective without a Mining Certificate specifying the precise deposits proven by the applicant and to be developed. The combination exploration-development license requires at some point after exploration but before development that the applicant apply for and receive a Mining Certificate.

Licensee. Customarily the license is issued to the Kazakstani party or to the Kazak-Foreign joint venture vehicle; however, this is not a legal requirement and licenses may be issued directly to the foreign investor.

Contents of license application. The foreign investor's license application should comply with the MinGeo's proposed *Draft Regulation On Licensing Procedures For The Use Of The Resources Of Kazakstan*. This Draft Regulation is now being implemented but still has not been formally approved. This Draft Regulation includes many provisions of which investors should be familiar when considering an application; this is especially so if a competitive international tender is announced for the exclusive license rights to the territory defined in the application.

Competitive bidding and awarding of license. As previously noted above, *Cabinet Resolution 377* may require a tender for the exclusive license rights. The license is granted or denied within 30 days following the publication in the local press of a notice of the investor's application.

Royalty rate. The Government has published a list of minimum royalty rates that it anticipates receiving for each type of mineral, although in specific cases these rates may be negotiated. Kazakstan's new Tax Code (adopted in 1995) also sets forth new guidelines for the determination of royalty rates (see below).

4. Issuance or re-issuance of the license. Regardless of the co-venturer in whose name the license is issued or reissued, the license should contain critical written assurances from the MinGeo and in some cases other organs of the Government. The following three clauses form an iron triangle, one in which the foreign investor will find either an protective fortress (if drafted properly) or an unprofitable prison (if neglected):

Most-favored investor clause. This clause should assure the licensee that any tax or other benefits granted to similarly-situated investors will be also extended to the licensee.

Impositions standstill clause. This clause should include a representation that except as scheduled, no tax, fee, or similar burden will be imposed by the Government during the term of the license, backstopped by a covenant that the licensee will receive a waiver of, or appropriate compensation for, any new or additional burdens. A similar protection is also afforded by Kazakstan's new Foreign Investment Law (adopted in 1995), although it is only applicable to investors meeting this Law's definition of a foreign investor (see below).

Assignment and exit clauses. The assignment, term, termination, renunciation-of-territory (if any), penalty, revocation, and notice-and-cure clauses must be carefully drafted. Oftentimes these clauses are sorely neglected in those cases where the Kazakstani partner applied for and received the license, this being especially so for licenses granted in the previous era where the interests of the State and the licensee merged sufficiently to yield an absence of precise and protective language. In particular, the foreign investor will need the right to assign the interest of the Kazakstani co-venturer (in the event of its default) to a Kazakstani party capable of performing.

5. Joint venture agreement. The joint venture vehicle might typically be capitalized via (i) a monetary contribution by the foreign investor (perhaps also including a non-monetary contribution of know-how, technology licenses, and equipment), and (ii) a non-monetary contribution by the Kazakstani co-venturer in the form of a Development License and a Mining Certificate (or other legal rights, on-the-ground facilities, and equipment). Importantly, as noted above, the joint venture agreement may need to be reviewed and approved by the authorized Cabinet-appointed body.

6. Tax holidays. Kazakstan's once-generous tax holidays have been largely eliminated in Kazakstan's new Tax Code, although existing joint ventures were protected by a "grandfather" clause preserving their prior tax benefits. Foreign investors should take care to either qualify for favorable tax benefits under the new rules, seek a special dispensation from the Government, or confirm that a pre-existing joint venture is still eligible to continue to receive tax benefits.

7. Finance. Financing a mining project will require adaptation to the lien laws in effect in Kazakstan, including the recently proposed changes to Kazakstan's land ownership and use regime. The lender in most cases will review carefully the license and the joint venture agreement examining in particular the assignment and exit clauses (see above). Likewise the lender will examine closely those statutory, regulatory, and contractual hindrances that may impede the lender's foreclosure rights to dispose of the project assets, most importantly the mineral rights granted under the license. Kazakstan's new Civil Code (adopted in 1995) will greatly enhance the clarity of the lender's rights, however, caution is urged until the adoption of the expected new law on secured transactions as well as the second part of the Civil Code which is now being finalized.

III. Privatization of mining enterprises

Many important Kazakstan enterprises in the mineral sector will be privatized in the near future, in most cases by selling significant stakes directly to foreign investors. The Kazakstan State Property Committee (the Russian initials are "GKI") – now reorganized into two separate privatization agencies – of the Republic of Kazakstan is charged with the administration of the Kazakstan National Privatization Program 1993–95 (Second Stage).

1. Introduction to the CBC privatization program. One important component of the Kazakstan National Privatization Program, namely the Case-By-Case (Individual) Privatization Program (or "CBC privatization"), provides for direct foreign investment into enterprises undergoing privatization. The CBC program is reserved for very large (over 5 000 employees) or unique enterprises. Consequently, the CBC program and includes many of the "crown jewels" of the Kazakstan economy, such as those engaged in the mining and processing of precious metals, other valuable non-ferrous metals, and some interesting ferro-alloys.

There are two main variants of CBC privatization:

(i) **Direct equity sales.** Direct sales of equity stakes to foreign investors are authorized under Cabinet Resolution 257 *On The Procedure For The Sale Of The State Block Of Shares* (adopted March 10, 1994) and related normative acts; and

(ii) **Management agreements.** Management Agreements may be granted to foreign investors under Cabinet Resolution 633 *On Measures To Implement Presidential Edict 1135* (adopted July 20, 1993) and related subsequent Cabinet resolutions, whereby the foreign investor is granted a power of attorney to control the management of the target company, and also granted a profit-sharing right and a share purchase option.

Direct equity sales in Kazakstan are not dissimilar to those under other privatization regimes, and are discussed below. Management Agreements, however, are experimental and in view of their significance in Kazakstan, are discussed in detail in below.

2. Specific mineral enterprises available. Thus far, the Kazakstan GKI (now reorganized into two newly created privatization agencies) has identified approximately 34 of Kazakstan's many mineral-sector enterprises as appropriate for CBC privatization in 1994-1995. An updated list of these enterprises may be obtained by contacting the author or the GKI. See Annexes 1, 2 and 3.

3. New leadership at the Kazakstan GKI. Kazakstan President Nazerbayev's recent Cabinet shake-up named Mr. Kalmuzaev as the new Chairman of the Kazakstan GKI. The Kazakstan GKI was also elevated to Cabinet-level status.

4. Policy shift regarding speed of CBC privatization: New Chairman Kalmuzaev has significantly accelerated CBC privatization in the mining, smelting, and refining sectors. This is in part due to the cash flow crisis experienced by many of these companies, which require immediate infusions of capital for electricity, wages, and raw materials. To facilitate this acceleration, the GKI adopted a general policy to grant Management Agreements (see below), thereby bypassing the often time-consuming process of a proper equity valuation of the target company.

5. Defining the mineral enterprise. Oftentimes the command economy environment produced state-owned enterprises ("SOEs") whose corporate structures were suboptimal from a market perspective. For example, a SOE targeted for CBC privatization may lack control over a related ancillary enterprise that is deemed essential to its functioning, or there may exist an upstream or downstream enterprises that should for reasons of industrial logic be integrated with the "target" enterprise. To remedy this defect in corporate organization inherited from the days of the command economy, the list of those entities slated for CBC privatization may be expanded to include the ancillary or upstream or downstream enterprise. The added enterprise is then "packaged" with the target enterprise for sale in a single international tender to a single investor.

6. Rules for bidding for mineral enterprises. Winning the tender for a Kazakstani enterprise and being nominated as the "preferred" bidder may be a deflating experience for the unwary investor who later discovers unrecoverable value lost during the bid-and-negotiation process. The rules regulating the authority of the Kazakstan GKI and the CBC Program are sometimes complex, and if not adhered to strictly may substantially diminish the value of, or even invalidate, a foreign investor's share acquisition. Accordingly, the assistance of counsel should be sought for a particular transaction. This remains more true now that the effect of the recent change in the leadership of the Kazakstan GKI is uncertain.

In Kazakstan, 1995 was the year of the "bonus payment bypass." Under an unregulated policy, a foreign investor could bypass an ongoing tender and prevail on the basis of a one-time cash bonus payment into Kazakstan's state budget made with the approval of Kazakstan's Cabinet Of Ministers (Cabinet). The EBRD, as well as a number of foreign investors who plodded through tenders for gold and other resources, reportedly have voiced concern over the lack of transparency in the bonus payment bypass.

7. Management agreements: Policy shift to management first, equity later. The CBC Privatization Program in 1994 primarily relied on negotiated sales of equity stakes. In early in 1995 Kazakstan's case-by-case privatization program (the "CBC Program") reoriented itself to provide a "fast-track" pathway to bring foreign investment into many Kazakstani enterprises, in particular major mining and smelting enterprises. This reorientation of the CBC Program now emphasizes the quick transfer of "management rights" directly to foreign investors pursuant to Management Agreements.

Economic pressure more than elegant policy caused the CBC Program to shift to "fast-track" Management Agreements. Defaults on payments to power suppliers, employees, and the tax collector have left most Kazakstani enterprises capital needy. In the specific case of the metal sector, advance sales of future concentrates and metal production (in some cases, 50 per cent or more of the following year's output) have left enterprises with anemic cashflow positions.

Over 15 major Kazakstani mining and smelting enterprises are now operating under outside management as a result of the conclusion of Management Agreements, with more to follow. Thus far, investment commitments exceeding 1 000 MUSD have been obtained from investors pursuant to Management Agreements. Investors receive under these Management Agreements a profit-sharing contractual management right coupled with a share purchase option. In exchange, investors provide outside management expertise and immediate financing.

Legal framework for management agreements. In 1993, the GKI was authorized pursuant to *Cabinet Resolution 633* which approved *Annex 2: On The Regulation Of Tenders To Conclude An Enterprise (Object) Management Contract*, as subsequently amended by *Cabinet Resolution 1370* (adopted December 5, 1994), to *transfer management control over state "objects"*, but does not specifically address the transfer of management rights where the state enterprise has already taken the first step away from direct ministerial oversight by being "corporatized." A "corporatized" state enterprise is one that has been transformed into a joint stock company, with shareholders, and a functioning corporate governance structure built on shareholder meetings.

Subsequently, *Cabinet Resolution 716* (adopted in May 1995) clarified that Management Agreements might be granted over corporatized entities, but no specific legal statement explained how this might be implemented.

Terms of management agreement. Under the Management Agreement concept, Western investors provide management expertise as well as immediate infusions of financing in exchange for a share of the Kazakstani mining company's operating profits and an option to acquire its shares within 5 years.

Standard Form. The GKI will proffer a "standard" form Management Agreement and try to quickly negotiate with foreign investors to accept its legal and financial terms without amendment. One drawback to this "fast-track" approach is that often legal due diligence and business feasibility does not precede the signing of the Management Agreement, but rather follows.

Financing Commitment. Immediate financing, from 25 to100 MUSD within 90 days of signing, is often demanded. The magnitude of the need is not unrealistic – though the tight timeframe well may be – because the great majority of Kazakstani mining companies have enormous debts for electricity and raw materials, as well as for unpaid wages and taxes.

Profit-Sharing. The percentage of the operating profit offered to a foreign investor during the management period might be anywhere from 1 per cent to 5 per cent, however, in many cases this is not an incentive where the company may not have a profit for the next few years, especially if it is paying down loans arranged by the managing company.

Share Option. The share option under a Management Agreement is typically exercisable at an agreed trigger price or formula at the end of 5 years (sometimes sooner) and preconditioned on fulfilling certain management obligations (such as increasing production, technology transfers, and arranging for operating capital).

Management company precautions. It is important in view of the ambiguous situation created by the existing legal framework to have any Management Agreement ratified by the Cabinet. In the only court case to date, Kazakstan's High Arbitration Court determined that one Management Agreement, notwithstanding that it was signed by the GKI, was not valid because it was not ratified by the Cabinet (the Butya v. GKI case involving the management right over the Karaganda Metallurgical Works).

As a further precaution, investors should require the GKI to execute a voting proxy so that the managing company can call a shareholder meeting to restructure management, when and if necessary. Although a power of attorney (in this case, a voting proxy) may be revoked at any time in accordance with Article 170.2 of the Kazakstan Civil Code (it may not be irrevocable), nonetheless this does provide the management company the assurance that the Government is serious about the transfer of management authority.

One implication for the management company is clear: the management company needs a voting proxy from the Kazakstan Committee on the Management of State Property in order to call a shareholders meeting and restructure management. A resolution of the Cabinet does not, in this author's view, substitute for a duly constituted shareholders meeting. This distinction is important because, as just one example drawn from a specific sector, almost all companies in the mining and smelting sector have been corporatized, with most having some significant number of shares (30 per cent or more in some cases) held by private owners. These private owners may object to any attempt to revert to an inapplicable administrative law basis for management control over the particular company that blocks their free exercise of shareholder rights.

8. Negotiation of privatization agreements. Typically, the Kazakstan GKI will negotiate with the preferred investor either of the following: (i) a Management Agreement combined with a Power Of Attorney (voting proxy), or (ii) a Foreign Investment Contract (essentially, a Share Purchase And Sale Agreement) combined with a Shareholders Agreement. Investors would be wise to seek the "iron triangle" of investor protections described above.

Management agreements (management with equity option). Notwithstanding the "standard form" Management Agreement (mentioned above) and the speed of negotiations, almost all terms of the Management Agreement are negotiable. These negotiable terms include: the magnitude and timing of the required financing, the scope of the technology transfer commitment, the size of the manager's cut of the profits (if any), the duration of the management right and the share option right, and the exercise price of the share option right.

Foreign investment contract (immediate equity stake). The CBC program does not, as of yet, demand that investors work from a standard set of transaction documents. Nonetheless, the Kazakstan GKI has identified certain criteria by which it will evaluate competing foreign investment proposals – such as capital investment commitments and employment maintenance commitments – and expects to see these commitments memorialized in the Foreign Investment Contract transaction documents.

Shareholders agreement (for immediate equity stakes only). In many cases the foreign investor seeks a control stake in the target Kazakstani enterprises, but control may be complicated due to the target's pre-existing ownership structure. Coordinating in advance the strategic direction of the enterprise will require the foreign investor to negotiate carefully a Shareholders Agreement with one of a number of Kazak-side parties.

First, a significant number of shares may be held, following the acquisition by the foreign investor of a substantial stake in the target enterprise, by a single Kazak-side party such as one of the privatization agencies (for example, the Committee For The Management Of State Property, or the Committee For The Privatization Of State Property) or a National Joint Stock Company (known generically in Kazakstan privatization circles as a "Holding Company"). One of the privatization agencies may have a mandate to privatize the remaining stake leaving the foreign investor to contemplate a future partner whose strategic and operational goals are unknown. A Holding Company typically will seek to negotiate a long-term business plan compatible with the Holding Company's strategic interests, which will be influenced by its interests in other mineral-sector enterprises (the largest Kazakstani Holding Company in the mineral sector owns no fewer than 40 subsidiaries engaged in mining, processing and other ancillary upstream and downstream activities). The foreign investor will want to negotiate the strategic and operational objectives to be pursued by the target enterprise, and memorialize these in a Business Plan incorporated into the Shareholders Agreement.

Second, in some cases the Government has retained a "golden share" in newly privatized companies, empowering it to veto certain decisions taken at the General Meeting (or Shareholders Meeting). The foreign investor will want to negotiate the scope and duration of this golden share in the Shareholders Agreement.

Control issues: Powers of attorney and amendments to the corporate charter. In the case of a Management Agreement, control over the target company is achieved via the execution of appropriate powers of attorney (preferably by the GKI for the right to vote its block of shares, and by the target company itself for the right to execute contracts and review management decisions). In the case of both a Management Agreement and Foreign Investment Contract, appropriate changes to the Charter of the target company may be appropriate.

Like all other enterprises slated for privatization under the National Privatization Program, enterprises targeted for CBC privatization must first be "corporatized," that is, transformed into corporations with shares available to be transferred to private owners. As a general rule this "corporatization" process occurs at the regional Oblast GKI administrative centers, which operate under the direction of the central GKI located in Almaty, using uniform incorporation/foundation documents. In CBC privatization, these uniform or standardized incorporation documents probably will require substantial amendments to address issues of importance to the selected foreign investor in various areas, such as for example voting rules, board representation, capital increases, rights of first refusal, corporate governance, and others.

IV. International auctions of selected mineral deposits

Three types of tenders are conducted by the Kazakstan Government for mineral deposits and mineral enterprises: (i) a *closed* tender limited to a select list of bidders, and *open* tenders of two types, namely, (ii) an open tender initiated as a result of the MinGeo receiving an offer from a foreign investor that is then "challenged" by other bidders, and (iii) an open tender that is initiated as a result of the MinGeo identifying mineral deposits it deems suitable for foreign investment. The first two types of tenders follow the principles set forth in above with some modifications and will not be discussed further in this section.

Accordingly, the following discussion concentrates on the third type of tender, which is best characterized as an international auction of select mineral deposits initiated and advertised by the MinGeo:

1. Controlled auction procedures. All three tenders mentioned above are "controlled" in that the initial bid price is accompanied typically by a set of transaction documents which the foreign investor is permitted to modify (possibly at the risk of diminishing the acceptability of the bid), and that subsequent to the initial round of bidding the leading bidders are typically invited to a second round of negotiations to develop their proposals. The open auction initiated by the MinGeo is typically more controlled, as it is accompanied by the advance publication of the bidding rules and bidders are charged entry fees in the form of fees for relevant geological data.

2. Joint venture agreement. The MinGeo has offered investors a "form" joint venture agreement in the most recent auction of approximately 40 deposits (the results of which are not final for most deposits). This "form" appears to be based on the Anglo-American model. One purpose of these international auctions is to attract investor interest in Kazakstan. In this particular auction, however, the form joint venture agreement may not have advanced that end as investors were uncertain to what extent deviations might be detrimental to their bids, especially in the case where the bidder was motivated by a desire to use a more Continental type of agreement. At LeBoeuf, Lamb, Greene & MacRae we seek to table documentation with which the bidder is most familiar, and then to focus on the crucial legal issues; the MinGeo might well be advised to adopt such a flexible approach in future auctions of this type.

3. Production-sharing agreement. In the most recent international auction referred to in the preceding paragraph, bidders were asked to enter into production-sharing agreements. While acceptable to certain investors, this normally would not be deemed customary for foreign investment transactions of this type. The risks inherent in investments into mineral deposits, and other factors, lead most investors to strongly prefer more traditional joint venture arrangements, including certain assurances regarding control over the project, export licenses, currency conversion and repatriation, and similar assurances.

Notably, the publication of the *Presidential Decree no. 2350 Concerning Petroleum* (adopted June 28, 1995) was accompanied by the publication of a "model" Production Sharing Agreement (the "Model PSA"). Surprisingly, the Government indicated it will seek to impose this Model PSA on all future investors in subsurface natural resources not only for oil and gas investment contracts, but also for hard mineral investment contracts. In all likelihood this Model PSA will not be used for hard mineral investment contracts, although it is notable in that it demonstrates again the Government's preference for this form of mineral development.

4. Future auctions and new procedures. It appears likely, based on indications from the MinGeo, that future open auctions initiated by the MinGeo will follow a different and more familiar route for investors. Bidders should retain counsel at the outset in all events to determine the possible parameters for such auctions and to determine the amount of leeway that might be permitted in structuring the bid proposal.

V. Metals trading and pre-export finance

Many Kazakstani mineral enterprises are cash-short and resource-long. The metals trader that can finance the export of metals as a commodity is greatly advantaged. Whether the metals trader finances the export using its own cash resources, or enters into a pre-export financing arrangement with a bank active in this business, in all events the metals trader will need to pay close attention to the legal requirements for securing the collateral back-stopping the financing arrangement.

1. Pre-export finance. Financing the export of metal using this commodity as collateral is more challenging in Kazakstan than in developed economies, but nonetheless may be accomplished by paying careful attention to the local law and business environment. In some cases, the financing will take the form of a traditional lending arrangement where the lender *loans funds* to the Kazakstani source in return for a lien on the commodity. Another approach, offering additional legal protection in some instances, is for the financing party to actually purchase commodities in order to take temporary legal ownership (title) of the commodity in the country of origin; this second approach simplifies the procedures for selling the collateral if the Kazakstani source who received funds defaults on the export arrangement.

The financing arrangements will customarily require an optimal blend of various financing precautions including among others:

- Casualty insurance;
- Warehouseman's fidelity or other insurance coverage in the event that the warehouseman or other custodian of the collateral fails to preserve the value of, or the possession over, the commodity;
- Appropriate verification by a qualified international control agent;
- Independent possession and control over the physical commodity itself to the extent feasible; and
- Political risk insurance from private insurers in London or New York to protect against losses from expropriation, confiscation or other similar political risk.

All of these precautions preserve the ready "salability" of the commodity that is the linchpin of an export financing transaction.

Finally, the *financing structure* may take one of two customary forms found acceptable by many financing parties. First, the financing may take the form of a collateralized pre-export purchasing facility, in which the financing company purchases the commodities for delivery at a later time (for example, eighteen months later). Second, the financing may take the form of a *collateralized trading facility*, in which the commodities are purchased in advance and payment is made via the acquisition and delivery of priority import items; this acquisition-and-delivery payment arrangement may be looked at favorably by commodity producing countries that desire to ensure that the receipts from commodities exports are not diverted but are actually used to ensure priority imports. In either case, the parties would be well-advised to consult counsel at the outset to structure the financing arrangements to meet the requirements of both the source producer and the exporter.

2. Export licenses. President Nazerbayev has issued edicts liberalizing the export of many non-ferrous metals by eliminating the monopoly on foreign export operations formerly held by Kazakstan's state export trading companies. This now permits the mine or smelter or refiner to directly export. Traders should carefully determine the duration of the export license, as well as verify that the local Oblast authorities have approved the price terms, before relying on their Kazakstani metal suppliers.

3. Security interest in moveables. A security interest in moveables – such as metals – may be perfected under Kazakstan law provided the proper legal means are used. Together with counsel, financing parties should examine the terms imposed on purchase-and-sale agreements and similar commercial agreements by (i) the law of the former USSR concerning the Basis For Civil Activities (still in effect in Kazakstan where not otherwise superseded by a specific contradictory item of Kazakstan legislation validly adopted subsequent to the de-federation of the former USSR), (ii) the new Kazakstan Civil Code, and (iii) certain applicable resolutions by Kazakstan's Cabinet Of Ministers that legally authorized the country's transformation to a market economy in the sphere of commercial relations between legal entities.

VI. Foreign investor precautions

Investors require that equity capital can be invested, recaptured and repatriated. This in turn requires an understanding of the tax regime and the currency exchange regulations affecting the particular investment scenario.

1. New foreign investment law. Eagerly awaited by foreign investors, Kazakstan's Parliament adopted a new *Law On Foreign Investments* on December 27 which was signed by the President on January 12, 1995. The new Foreign Investment Law favors foreign investment in part, but not in whole. The new balance reflects current thinking in the Government.

From the perspective of the foreign investor, the new Foreign Investment Law is in part superior to the prior law, the foreign investment law of 1990. Foreign investors should welcome the more expansive and specific language defining the pledge against expropriation. Foreign investors should also be pleased with the new "standstill" pledge that assures investors that critical components of the overall investment climate will not deteriorate from the date of the investment.

The new Foreign Investment Law restates in statutory form many policies the Kazakstan Government implemented in 1994. Importantly, the new Foreign Investment Law re-states the current Government's thinking with regard to reduced tax incentives for foreign investors. In addition, more stringent requirements have been instituted to limit Government guarantees for foreign investment projects. While foreign investors may not welcome these particular changes, the Government has eliminated the uncertainty regarding the fate of these and other policies affecting foreign investors.

Standstill pledge. The new Foreign Investment Law reassures foreign investors who fear that future tax increases and other governmental impositions will drain their investment projects of commercial viability. Specifically, the new Foreign Investment Law pledges that the legal regime in effect on the date of the investment will be at a "standstill" for 10 years (or longer in the case of certain contracts with government agencies). Exceptions from this standstill pledge in-

Annex 1. List of enterprises in the metals sector indentified for CBC privatization in 1994 – 1995

1. Donskoy Mining and Concentration Kombinat (chrome)*
2. Aktyubinsk Plant of Chrome Compounds (chrome)*
3. Aktyubinsk Ferro-Alloys Plant (ferro-alloys)*
4. Chilisai Production Association (copper ore)
5. Chromtau Mining Directorate of Kazshakhtorudstroi Trust (mine construction and operation)
6. Kimpersai Ore Directorate (nickel ore)
7. Turgay Bauxite Ore Directorate (bauxite ore)*
8. Dender Production Association (borate ore)
9. Irtysh Chemical and Metallurgical Plant (rare metals)
10. East-Kazakstan Copper and Chemical Kombinat (copper and zinc)*
11. Irtysh Polymetallic Kombinat (copper, zinc, lead and barite)*
12. Zyryanovsk Lead Kombinat (lead)*
13. Byelogorodska Mining and Combination Kombinat (mining)
14. Vostokgeologia Production Association (geological surveys)
15. Akbaiski Mining and Concentration Kombinat (gold ore)*
16. Balkhashmed Production (copper ore)*
17. Zhezkazgantsvetmet Research and Production (copper ore)
18. Karagandashakhtstroi Trust (mine construction)
19. Shalkinskoye Ore (non-ferrous metals)*
20. Sokolovsko-Sarbayskoye Mining and Production (iron ore)*
21. Lisakovski Mining and Concentration (iron ore)
22. Krasnooktyabrskoye (bauxite ore)
23. Maikaimzoloto Mining (polymetallic ore)*
24. Pavlodar Aluminum Plant (aluminum)*
25. Yermakovski Ferro-Alloy Plant (ferro-alloys)
26. Altaizoloto Mining and Concentration Kombinat (gold ore)
27. Bakyrchik mining and Metallutgical Kombinat (gold)
28. Geological Prospecting Firm (geological prospecting)
29. Tekeli Lead and Zinc Kombinat (lead and zinc ore)*
30. Tselinni mining and Chemical Kombinat (uranium ore)
31. Kazzoloto Mining and concentrations Kombinat (gold)
32. Achisai Polymetallic Kombinat (lead, zinc and barrite ore)*
33. Yuzhkazgeologia (geological surveys)*
34. Ust-Kamenogorsk Titanium and Magnesium Kombinat (titanium and magnesium production)*

* Slated for the first wave of CBC privatization commencing in mid-1994.

Annex 2. Significant management agreements awarded

According to publicly available information – local press reports and official Government resolutions – the following Kazakstani companies have been awarded to private-sector investors to operate under a Management Agreement:

1. Pavlodar Aluminum (awarded January 1995 to Transworld or one of its affiliates).
2. Tekeli Lead And Zinc Kombinat (awarded April 1995 to the Swiss firm Projector, although local press reports named the Swiss firm Laurence Trading Ltd. as the Western manager).
3. Donskoi Chrome Mining (awarded in April 1995 to a Mitsui-led group).
4. Dzhezkazgansvetmet Copper (awarded in April/May to a Liechtenstein firm Tenida Angel, although recent press reports indicate a major Korean industrial group is the key player).
5. Leninogorsk Polymetallic Kombinat (awarded April 1995 to a Kazakstani firm that reportedly has the participation of a major Western investor).
6. Aktau Kombinat (awarded to the Kazakh firm Industry-Financial Company Akzal-Invest).
7. Sokolovsk-Sarbaiskoye Mining And Industrial Association (SSMIA) (ferrous metals) (awarded in early 1995 to the Iceland firm Aivedon, which is working together with the Chinese firm Suar).
8. Yermak Ferrochrome-Alloys (awarded recently to an undisclosed firm with both Kazakh and foreign investors).
9. In addition, some non-mining companies have also been awarded to private-sector investors pursuant to a Management Agreement, including Almaty Tea Factory, Almaty Margarine Factory, and Pavlodar Oil.

Annex 3. See page 24.

clude changes in the legal regimes for national defense, the environment, and public health and morality.

Elimination of tax holidays. The 1990 foreign investment law granted foreign investors or joint ventures where the foreign participant's share exceeded 30 per cent reduced rates of profits tax and other tax incentives. These tax incentives have been eliminated in the new 1995 Foreign Investment Law. Notwithstanding the elimination of universally available tax incentives, foreign investors should be aware that the Kazakstan Government may negotiate tax incentives for foreign investment projects on a case-by-case and sector-by-sector basis.

Settlement of disputes. Foreign investors have had problems in the past obtaining international arbitration for contract disputes. The new Foreign Investment Law provides that the results of international arbitrations will now be enforceable within Kazakstan in accordance with existing legislation. The international arbitration must be conducted through specific arbitration regimes, including ICSID and the ICC in Stockholm. Recently, Kazakstan joined the New York Convention (1958) which further simplifies the enforcement of arbitral awards in Kazakstani courts.

2. Tax regime. Specifically, the investor should examine the tax regime applicable to income derived from the foreign investment, including: tax holidays, capital gains and ordinary income; dividend withholding; securities transfer tax; value-added tax; available double-taxation treaties; and the taxes applicable to any Kazakstani operating entity that plays a material financial role in the inbound investment program.

Finally providing foreign businesses operating in Kazakstan much hoped-for tax certainty, Kazakstan's President Nazerbayev signed on April 24, 1995 Presidential Edict No. 2235 *Concerning Taxes And Other Compulsory Payments To The Budget* (the "Tax Code"). Given the uncertainty in Kazakstan concerning taxation, most investors welcomed the Tax Code though specific provisions may be less favorable for a particular investment scenario. For example, as noted in above, there are recently imposed limitations on the availability of Kazakstan's once-generous tax holidays.

Section VI of the new Tax Code establishes a regime for the taxation of the use of the "subsurface," including oil, gas, and hard minerals. This regime includes the following payments to the state budget:

- Bonus payments, such as a one-time fixed subscription or discovery bonus, and a periodic fixed-amount extraction bonus;
- Royalties;
- Windfall profits taxes.

The Cabinet Of Ministers has been authorized to form a separate state agency to establish and approve the amount of bonus payments, whereas the contract for the use of the subsurface will control by stipulation the amount of the royalty and the amount of the windfall profits tax.

3. Currency regime. Likewise, the investor should examine the currency exchange regulations applicable to the importation and holding of hard currency, including: contributions of capital to Kazakstan juridical entities in the form of hard currency; the repatriation of dividends in local or hard currency; and the provision within the country of investment, or the export outside of the country of investment, of products or services to hard currency purchasers. Kazakstan departed the "ruble zone" late in 1993, and since that time its new currency – the tenge – has weakened substantially against the dollar, falling from approximately 4.5 tenge to the dollar at its introduction to 64 tenge to the dollar in December of 1995.

4. Customs regime. In a departure from prior Kazakstan law, customs duties are now applied to foreign contributions to the charter capital of the joint venture company, such as the import of mining machinery and other capital assets used to extract minerals. We are aware of exceptions to this rule granted on a case-by-case basis by the Cabinet for specific projects. Counsel should be sought to identify beforehand any possible customs benefits that may be obtainable.

5. Capital entry and exit legal memorandum. Accordingly, investors should, at the outset, seek counsel to assist in structuring the transaction so as to maximize tax efficiency and minimize currency exposure. Investors might consider requesting counsel to prepare a *Capital Entry And Exit Legal Memorandum*, which serves as a "country analysis" for the particular investment scenario under consideration.

Note

[1] The Ministry of Industry – now merged with the Ministry of Trade and the Ministry of Foreign Economic Relations and re-formed as the Ministry Of Industry And Trade – for its part may play a role as the founder of important Kazak mining enterprises that may act as co-venturers or play a role as a member of the authorized Cabinet-appointed body charged with the review of agreements for the exploration and extraction of minerals. ■