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IMPACT OF THE FATF GREY LISTING ON FDI INTO MONGOLIA

OVERVIEW

In October 2019, the Financial Action Task Force (“**FATF**”) included Mongolia into its watchlist (the so called “**Grey List**”). From the outset, this could increase the concerns of investors around economic stability, smooth international transactions, and free flows of currency. If the Grey List status lasts for a significant length of time, this could develop into more serious problems, but we believe this status should be corrected within a short-term period and do not expect that it will have a material medium or long-term impact on FDI.

POTENTIAL SHORT-TERM RISKS

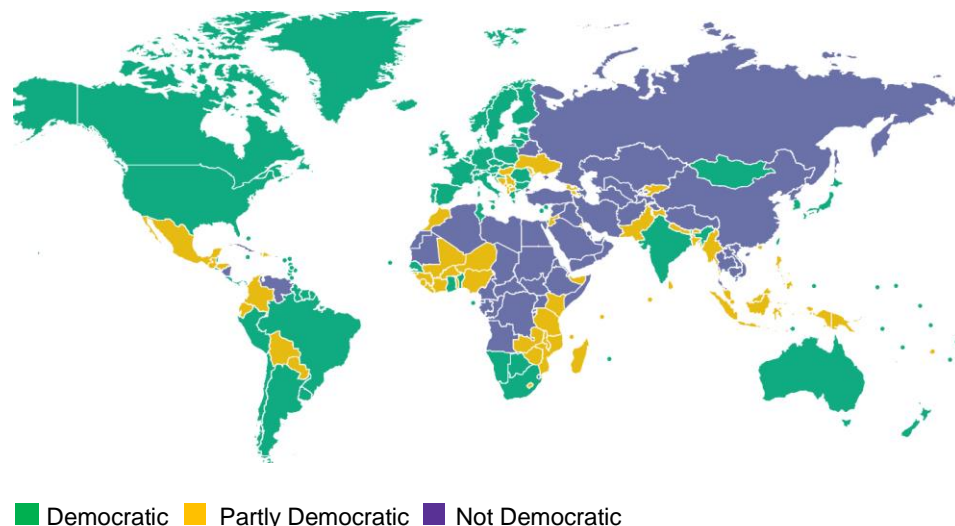
Some short-term risks associated with the Grey Listing could include the following:

- Correspondent banks processing US dollar transactions with Mongolian commercial banks already face a significant regulatory burden and comparatively low transaction volumes. Enhanced oversight required as a consequence of the Grey Listing, could stretch existing relationships and impact on US dollar transactions
- Mongolian commercial banks may limit transactions in US dollars as the MNT/USD exchange rate is put under increased pressure
- If Mongolia is not able to reverse the Grey Listing in the short-term, there is a risk of increased reliance on its neighbors, China and Russia, due to a greater perceived risk for US, European, Australian, and Asian investors may be enhanced

Regardless of the current Grey Listing, since the foreign investment boom into Mongolia between 2010-2012 (when ironically Mongolia was also on the Grey List), there have been numerous other issues and obstacles to attracting FDI. This is dependent upon various external and internal factors, but we believe Mongolia still has good potential to attract FDI. Some of the main points underpinning this are set out below.

1. STRATEGIC LOCATION AND DEMOCRACY IN THE REGION

Democracy index map¹



Mongolia is regarded as the only democratic country located in North and Central Asia, sandwiched between China and Russia, two important players in the world economy and geopolitics. With an area of more than 1.5 million square kilometers and a population of about 3.2 million, Mongolia has recently topped lists as one of the world’s fastest growing economies, holding a massive wealth of mineral resources.

¹ <https://freedomhouse.org/report/freedom-world/freedom-world-2019/map>

2. COMPARATIVELY LIBERAL LEGAL SYSTEM

Mongolia is considered as a Civil Law, and not a common law country. The Mongolian legal system, established by the 1992 Constitution, is a civil law system primarily based on the continental or Romano-Germanic tradition, where judicial decisions do not incorporate any binding rules into the body of law in the same way as judicial precedents in common law. The Civil Code of Mongolia itself is ostensibly modelled on the major continental European codifications, in particular the German Civil Code.

However, in practice, the sources of the Mongolian legal system are far more complex and diversified than is often described by academics. The reason for this is that several multilateral and development agencies, technical assistance programs and foreign advisors and academics from various countries have been involved in the drafting of new legislation. As a result, many business-related laws are somewhat similar to common business legislation used in western countries.

Furthermore, the Civil Code also sets out an important characteristic of the Mongolian legal system - the principle that commercial acts are lawful so long as they do not conflict with existing laws. In other words, Mongolia has adopted a principle similar to the common law notion of "that which is not prohibited is permitted."

3. INVESTMENT PROTECTION

Replacing the 1993 Law on Foreign Investment, and the controversial 2012 Law on the Regulation of Foreign Investment in Business Entities Operating in Sectors of Strategic Importance, the Parliament passed a new Investment Law in 2013. The Investment Law eased the regulatory approval requirements and streamlined the registration process for foreign direct investment. Further, it sets out certain legal guarantees and incentives so as to promote investment activity in Mongolia.

Some of the key features of the Investment Law are:

- (a) It applies to both foreign and domestic direct investment;
- (b) No approval requirements are imposed on foreign private investment;
- (c) It provides legal guarantees to protect investment in Mongolia and sets out tax and non-tax incentives so as to promote investment in Mongolia;
- (d) It offers tax stabilisation incentives in the form of tax stabilisation certificates and investment agreements; and
- (e) Foreign invested business entities incorporated in Mongolia are eligible to acquire most types of licenses.

More importantly, any illegal expropriation is prohibited and protection against expropriation is ensured in compliance with international standards and criteria of lawful expropriation. It is prohibited to expropriate investors' property unlawfully. Further, subject to any Bilateral Investment Treaties, investors' property may be only expropriated if:

- (a) the purpose of expropriation is solely for the public interest; and
- (b) full compensation at market price is provided.

In addition, Mongolia is a party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (the "**New York Convention**") and it is possible to enforce foreign commercial arbitral awards in Mongolia. Domestically, the Law on Arbitration ("**Arbitration Law**"), enacted on 26 January 2017, the Law on Civil Procedure, enacted on 10 January 2002 and the Law on Enforcement of Court Decisions, enacted on 10 January 2002 govern the procedure for the recognition and enforcement of foreign arbitral awards in Mongolia. Further, foreign investment is broadly protected by numerous instruments, such as international treaties, under which the Mongolian government has been brought to international arbitration by foreign entities, and arbitral awards have been enforced in Mongolia.

4. **LOW CORPORATE INCOME TAX**

Mongolia recently revised the Law on Business Entities Income Tax in March 2019. The revised law will be effective from 1 January 2020 and provides better incentives to business entities due to a decrease in income tax rates. For example, the 10% income tax rate threshold for business entities up to 3 billion MNT will be doubled to 6 billion MNT, and the 25% income tax rate will now apply to business entities with income above 6 billion MNT. Tax on business entities with income up to 300 million MNT will now be 1%. Further, the Revised Law promotes foreign investment by means of various provisions to secure stabilized tax.

5. **SHAREHOLDER RIGHTS AND LIBERAL COMPANY LAW**

The enactment of the revised *Law on Company* ("**Company Law**") in 2011 was an important step towards the government's aim of bringing Mongolian corporate governance standards closer to those found in more developed jurisdictions. The Law on Company secures fundamental shareholder rights and privileges. This includes typical pre-emptive rights, voting rights and the right to bring a derivative suit against the governing persons of a company in the event of loss. Furthermore, a company's charter or shareholder agreement can increase the standard thresholds for various approval requirements, and add other typical shareholder rights such as tag-along and drag-along rights.

6. **OTHER POINTS**

These fundamental points are all important factors to attract long term investment. Just to add several other advantages, the following can also be pointed out:

- (a) there are no legal currency controls for international transactions;
- (b) no residence and no-citizenship requirement for board directors and/or key managers of a Mongolian-invested company;
- (c) all "Big 5" audit companies have a presence in Mongolia, and financial and tax reporting has been simplified in recent years; and
- (d) foreign-invested companies can apply for all business licenses to legally the same extent as national companies.

7. **CONCLUSION**

To conclude, although Mongolia appears to have lost attraction for foreign investors in recent years, we consider that the basic fundamentals and system are in place to attract long term FDI into Mongolia. In order to encourage FDI investment into the country, policy makers need to focus on some of the practical legal issues which impact all businesses. For example, in practice, there is still inconsistent enforcement of Mongolian regulations and laws. Some laws create disparities in understanding and result in patchy and inconsistent enforcement. This sometimes gives government officials discretion to impose requirements that are not stipulated in the law, which can encourage corruption and malpractice at an administrative level. Likewise, the court system remains erratic and unpredictable, which, in turn, damages the legal and business environment for FDI.

If you would like to further information on any aspect of this note, please contact a person mentioned here or the person with whom you usually deal.



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