

THE LEGAL TREATMENT OF FOREIGN INVESTMENT UNDER KAZAK LEGISLATION: AN OVERVIEW

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1. General Characteristics

Attracting foreign investment to the economy of Kazakhstan is a strategic goal of economic policy, without which economic development can neither intensify nor expand. However this process also has another dimension: it requires the creation of the necessary legal framework for attracting investment and its solid incorporation into the republic's economy. For precisely this reason, the government of Kazakhstan has made numerous efforts, since the beginning of its independence, to create the essential legal basis for a favorable climate for investors.

Kazakhstan's legislation on investment has undergone several changes during the decade of its development, and has come a long way from being a "legal desert" to becoming a relatively developed legal system. At the present time however, the system is not optimal or detailed enough, *i.e.*, is not legally perfect. Nevertheless, it must be admitted that the results of the creation of investment legislation are quite formidable, considering that ten years is not a very long time for its development under the pressure of major economic changes and crises. This is all the more significant when one considers that, especially during the first years, there was an almost complete absence of necessary legal knowledge and familiarity with international practice. At present, Kazakhstan has not only developed a system of investment legislation, but – what is equally important – the level of legal understanding in this sphere has increased considerably not only among professional lawyers, but also among the majority of entrepreneurs, as well as (at least) the progressive faction of state officials and members of the parliament.

In evaluating the modern system of Kazakhstan legislation on foreign investment, it is important to keep in mind that along with the pivotal Law of

the Republic of Kazakhstan "On Foreign Investment",¹ there is also a relatively large number of laws, normative acts of various levels and character, as well as international agreements, that directly or indirectly regulate the legal treatment of foreign investment; and only an integral analysis of this entire body of legislation enables comprehension of the system as a whole.

Among the special investment laws, mention should be made of the Law of the Republic of Kazakhstan "On State Support for Direct Investment",² which regulates direct investment – foreign as well as domestic. The laws of the Republic of Kazakhstan regulating relations in specific economic spheres very often contain references to the legal status of foreign legal entities and individuals. For example, one essential law for foreign investors is the Law "On Underground Resources and their Exploitation",³ which has a provision stipulating that foreign citizens and legal entities, as well as persons without citizenship, exercise rights and bear duties in respect to the exploitation of such resources on par with citizens and legal entities of the Republic of Kazakhstan unless otherwise stipulated by the Law or other legislative acts (section 4, Article 4).

Of course, the most important part of the legal system as regards foreign investment are international agreements. Between 1992 and 1998, the Republic of Kazakhstan signed some thirty agreements with other countries on the promotion and mutual protection of investments; in 1999 a number of such agreements were also signed. The major part of these agreements are currently in force, including those with the United States, Great Britain, Germany, China, Turkey, and other countries.

2. The First Law of the Republic of Kazakhstan on Foreign Investment

The first Kazakhstani Law on Foreign Investment was adopted on 7 December 1990, *i.e.*, before the declaration of the independence of The Republic of Kazakhstan and the collapse of the USSR. It defined the concepts of foreign investors and foreign investment, and stipulated a number of privileges for them, beginning with tax and customs privileges. At the same time, the Law failed to resolve many important questions regarding the legal treatment of

1. Adopted by the Supreme Soviet of the Republic of Kazakhstan on 27 December 1994 with amendments made on 2 August 1999. Published in *Vedomosti Verkhovnogo Soveta Respubliki Kazakhstan* 1994 No. 23-24 item 280.
2. Adopted by the Parliament of the Republic of Kazakhstan on 28 February 1997 with amendments made on 2 August 1999. Published in *Vedomosti Parlamenta Respubliki Kazakhstan* 1997 No. 4, 50.
3. Adopted on 26 January 1996 by Edict of the President of the Republic of Kazakhstan that has the force of the law, No. 2828, with amendments of 11 August 1999.

foreign investment – above all, guaranteeing protection of investors' interests in case of legislative or political instability or when bodies of state power (or state officials) commit wrongful acts. In addition, in our view, the Law contained excessive limitations on investor's activities.

The December 1990 Law could not be based on the already accumulated experience of the USSR because after its collapse this was precisely the sphere that underwent the most radical changes, since during Soviet rule the state had enjoyed a monopoly over all foreign economic relations. The problem, however, was not only that the state had exclusive control of international trade policy (the state had a monopoly on domestic economic policy too), but also that all Soviet foreign economic relations, including foreign investments that had barely started, were controlled entirely by Moscow; the Soviet republics were virtually out of the picture. Under these conditions, the first Law on Foreign Investment in the Republic of Kazakhstan could outline only the basic conditions for building relationships with foreign investors.

3. The Law on Foreign Investment of 1994

Shortly thereafter, a new Law on Foreign Investment was prepared and was adopted by the Parliament of the Republic on 27 December 1994. This Law remains in force, although various essential amendments have been introduced since its passage. The amendments will be discussed below.

The Law stipulated the concept of *foreign investment* (and, consequently, defined the details of its legal situation) and *foreign investors* (and consequently defined their legal status). One of the main tasks of the Law was to create conditions for attracting foreign investment to the Republic of Kazakhstan and for protecting foreign investors' interests against violations not only by their economic partners in Kazakhstan, but also by the state, (bodies of state power, and state officials).

With that end in view, the Law stipulated that any form of foreign investment, as well as any other activity related to investment, be implemented under conditions no less favorable than the ones provided for Kazakhstan investors or for other foreign investors, depending on which conditions appear to be more favorable. The possibility of providing additional privileges for foreign investors was also outlined (section 4, Article 5 of the Law.) Special legal regulations ensured legislative and political stability for foreign investors (Article 6), guaranteed protection of foreign investors' interests against unfavorable changes in legislation (including tax legislation), against expropriation (Article 7), and against wrongful acts of the bodies of state power and officials (Articles 8, 9, 13).

The main method of protection was to be enforcement of the relevant law in force at the moment of investment, as well as complete and immediate monetary compensation of all property losses caused by unlawful acts of any level of the government system.

The Law also guaranteed foreign investors freedom of action in the use of gained profit (Article 10), their own hard currency resources (Article 11), and in the import of necessary property (Article 22). Considerable attention was paid to the order of creation and activity on the territory of Kazakhstan of businesses with foreign partnership, as well as their subsidiaries, branches and representative offices.

The Law's obvious intention to protect foreign investors' interests follows from the content of Article 27, which stipulated the order of resolving investment disputes.

In addition, the norms of the Law providing the guarantee of legislative and political stability were endowed with retroactive effect, *i.e.*, their operation covered foreign investments that were initiated before the Law in question was adopted.

At the same time the 1994 Law made provisions for a number of limitations on the activity of foreign investors: they were allowed to participate in the privatization of state property only on conditions stipulated by special legislation (section 2(b), Article 4 of the Law); provisions were made for the possibility of limiting foreign investors' activity in certain territories of the Republic; the Republic's responsibility for government actions connected with foreign investment was also strictly defined.

Occasionally, certain inaccurate statutory wordings allowed for different interpretations. In the first place, this pertains to the disparity in the boundaries of the concepts "foreign investment" and "foreign investors". The problem was that investment for the creation of businesses with foreign partnership was considered (and is still considered) foreign investment. But these businesses, formed and registered on the territory of the Republic of Kazakhstan, were defined by the Law not as foreign, but as domestic investors. As a result, there were certain interpretations of the Law according to which privileges and guarantees provided for foreign investors did not cover the activity of businesses with foreign partnership, even though these businesses were often financed through foreign investment and were even officially called "foreign businesses".

In addition to the Law on Foreign Investment, the legal treatment of foreign investment in the Republic of Kazakhstan is defined by various by-laws, first of all on the level of the Presidential Edicts and decrees of the Government of the Republic of Kazakhstan. They are concerned with questions of attracting foreign credits to the Republic of Kazakhstan and invest-

ment in the development of agriculture, the oil and gas industry, etc. Certain edicts of the President and decrees of the Government, especially those concerned with the oil and gas industry, contained stabilizing regulations that guaranteed the investor the invariability of legislative and contractual conditions, as well as made provisions for special legal regimes. For example, the Edict of the President of the Republic of Kazakhstan "On the Joint Venture "Tengizchevroil" (signed on 4 May 1996) provides that for the joint venture "Tengizchevroil" and its foreign suppliers, the regime of economic, tax, and legal stability, foreseen by agreements made at the time of creation of the joint venture "Tengizchevroil" in April of 1993, would be maintained. An Edict of the President of the Republic of Kazakhstan "On the Caspian Oil Pipeline Consortium" (signed on 19 April 1997) allows the Joint Stock Company "KTK-K" to receive foreign currency from the residents of the Republic of Kazakhstan for the service of transportation of liquid hydrocarbons. The Decree of the Government of the Republic of Kazakhstan "Issues related to the Caspian Oil Pipeline Consortium" (signed on 20 March 1997) stipulated that in the case when creation, change, or termination of the operation of legislative acts and international agreements aggravates the conditions of economic activity of foreign investors in "KTK-K", the latter can follow conditions of the legislature, agreements and requirements, that were in force at the moment of initial investment.

As more experience was gained of implementing the 1994 Law On Foreign Investment, proposals accumulated from interested agencies and members of parliament, directed toward improving on the one hand the investment climate as well as strengthening the protection of government interests on the other. This was the reason for introducing amendments to the text of the Law. Some of these amendments have significantly influenced the legal treatment of investment and the situation with foreign investors. The most important amendments made to the Law were adopted on 16 July 1997 and 2 August 1999. The legal treatment of foreign investment was furthermore subjected to major changes by the Law on Governmental Support of Direct Investment, adopted on 28 February 1997.

4. The 1997 Amendments to the Law on Foreign Investment

On 16 July 1997, further refinements were made to the definition of the concept of foreign investment, bringing it closer to that which emerges from international agreements supporting foreign investment, of which the Republic of Kazakhstan is a participant. A definition of "applicable law" was created specifically for the Law on Foreign Investment – this right is acknowledged to be the right of the Republic of Kazakhstan unless otherwise

stipulated by agreement with an investor. However, certain relations, directly prescribed by the legislative acts of the Republic of Kazakhstan, can be regulated only by Kazakhstani legislation. The most prominent examples are Articles 1114 and 1115 of the Civil Code, in force from 1 July 1999, on the application of the Kazakhstani legislation to the agreements on the creation legal entities with foreign partnership. Prior there, a similar norm was contained in Article 166 of the 1991 Principles of Civil Legislation of the USSR and the Union Republics.

The amendment of Article 4 of the Law On Foreign Investment removed limitations on foreign investors' participation in the privatization of government property.

Another important step in the direction of establishing more comprehensive protection of foreign investors' interests was the inclusion in the Law On Foreign Investment of a rule stipulating that the guarantees for foreign investors foreseen in Articles 6-10, 12, 13, and 27 of the Law are also applicable to protecting the interests of those businesses with foreign partnership, in which a foreign investor holds a significant share of the nominal (charter) capital. Article 5, which limited the Government's ability to provide guarantees for foreign investors, and exempted the Republic of Kazakhstan from responsibility for the acts and decrees of the Government, was removed from the text of the Law. Amendments to the Article 27 of the Law, introduced on 16 July 1997, upheld the right of foreign investors to choose a forum (including international commercial arbitration court) for resolving investment disputes.

All this, undoubtedly, has improved the investment climate of the country and strengthened and solidified the protection of foreign investors' interests.

At the same time, the 1997 amendments aggravated considerably the conditions for investment activity for certain investors and types of foreign investment. In particular, this pertains to investment in those types of commercial activities which the government does not intend to support. These are directly listed in section 4, Article 6 of the Law on Foreign Investment (as revised by the 1997 amendments: import, production, and distribution of excisable products (first of all – tobacco and alcohol products), and the import of products meant for sale without (re)processing, *i.e.*, solely for re-sale. These types of activity on the part of foreign investors were excluded from the regime of legal stability, *i.e.*, foreign investors were now subject to changes in the law, international agreements, as well taxation, customs duty, increases in excise duties, etc. that made matters worse for them to the same degree as were domestic importers, producers, vendors, etc.

As if that weren't enough, this "legal innovation" was endowed with retroactive effect: it applied not only to funds invested into the types of

activity that had been listed in section 4 after the amendment, but also to investments in the import, manufacture, or sale of excisable goods, as well as the import of goods meant for sale without processing at the time when these types the activity were embraced by the regime of legal stability.

Other amendments to the Law introduced on 16 July 1997 made matters (even) worse for all foreign investors. For instance, an amendment to the Article 22 reduced specific customs privileges.

5. The 1999 Amendments to the Law on Foreign Investment

As recently as 2 August 1999, the Law on Foreign Investment underwent certain small but nevertheless radical alterations. These were introduced only in Article 1 of the Law but they concern two key concepts: those of the foreign investor and of foreign investment. In particular, legal entities the decisions of which foreign investors have a right to determine were now included into the concept of "foreign investor" in the Republic of Kazakhstan. As one can see, this definition eliminates the incongruity, mentioned earlier, between "foreign investor" and "foreign investment" that allowed a foreign enterprise set up in Kazakhstan, the principal capital of which has been entirely procured by a foreign investor to be considered a domestic investor. In fact, we have returned to the definition of foreign investor used in the 1990 Law on Foreign Investment. In our view, it provided better protection for the interests of foreign investors who put capital into the formation of Kazakhstani legal entities.

However, some of the 1999 amendments to the Law on Foreign Investment seem to us to be questionable not only do they worsen the investment climate in the Republic, but they are also baffling in their divergence from other norms of the Law. We are referring to the definition of a "foreign investment". To our mind there is no need for such a definition. Since Article 1 of the Law contains an adequate definition of "investment" and "foreign investor," one would think that the logical definition of foreign investment should simply be that of "an investment made by a foreign investor." And that is exactly how this concept was formulated in the previous version of Article 1 of the Law. Instead of using this definition, however, the 1999 amendment to the Law has now defined foreign investment as an "investment in the form of a share in the principal capital of those legal entities of the Republic of Kazakhstan, and as loans (credits) to legal entities of the Republic of Kazakhstan, the decisions of which a foreign investor has a right to influence".

In this way, a definition meant to bring together “investment” with “investors” has artificially remained a bifurcated one. It embraces only a part of foreign capital investment.

It remains unclear how to define other investments clearly made into the economy of the Republic of Kazakhstan by an investor who is clearly foreign. No answer has been given which opens the way to legal arbitrariness. Besides, in the amended version of Article 1, the generic definition of a “foreign investment” overlaps with the sub-generic concept of “a direct foreign investment”.

Therefore, the amended version of the Law regards as foreign investment only the capital investment enabling a foreign investor to determine the decisions of Kazakhstani legal entities. And these can only come in three situations: a) the purchase of a controlling block of shares; b) the purchase of a majority share of the charter capital; c) providing credit upon conditions (convenants) that allow interference in corporate management. The Law, therefore, ignores a sizeable number of foreign investments where the block of the purchased shares does not constitute a majority of the charter capital or the cases where long-term credits that finance the production basis of the Kazakhstani legal entity which is being created do not imply the creditor’s participation in the management of the legal entity. As of now, the definition of foreign investment does not cover an important relationship such as production-sharing agreements (PSA), with the exception of the cases when one or more foreign companies carry out the investments registered in a PSA with Kazakhstan through a legal entity registered in Kazakhstan (which is not a required or widely-practiced approach).

But one should look further. The very concept of an investment as defined by Article 1 of the Law covers *all types* of material and intellectual assets that investors may invest into objects of for-profit entrepreneurial activity, and these assets can take various forms in addition to investments in charter capital or extensions of credit. The by no means short list in Article 1 of the Law also mentions such forms of: investment as bonds and other certificates of indebtedness; participation in commercial activity other than shares; rights to any type of activity permitted by law, and so forth.

How does one then evaluate investment made by foreign investors in the forms mentioned above? This is not foreign investment, apparently. Is it, then, domestic?

There are dozens of foreign investors currently active in Kazakhstan who do not participate in the creation of Kazakhstani legal entities or share commercial decisions with them, but who do contribute to the improvement of the economy. Those are the parties in production-sharing agreements, concession, joint activities, contracting agreements etc. Some large projects

are carried out by foreign investors via branches and representations without creating their own legal entities on the territory of Kazakhstan. It turns out, however, that their capital investment is not regarded as foreign investment.

This problem requires very careful consideration because it could have negative practical consequences and also could seriously weaken the protection of foreign investment as well the interests of foreign investors.

There is another possible interpretation of the law: the privileges granted to all foreign investment in the earlier meaning of the term will – from now on – apply only to those investments that were made after the 2 August 1999 amendments to the Law on Foreign Investment and are limited to creating and providing credit to a legal entity which is truly managed by a foreign investor. All other types of capital investments by foreign investors are not entitled to these privileges nor to the protection of the interests secured by the Articles 4 and 6-9 and by other Articles.

The interpretation of investment-related disputes also differs when such disputes have not arisen from the formation of, or the extension of credit to, a Kazakhstani legal entity. Consequently, foreign investors' choice for dispute resolution mechanisms is reduced to a very limited number of the bodies. All in all, interpreting of those norms of the Law that simultaneously discuss both foreign investors and foreign investment has become problematic because not all investments made by foreign investors are regarded by the Law as foreign.

6. Conflicts between the Kazakhstani Law on Foreign Investment and International Agreements

We should not overlook the fact that the proposed new interpretation of foreign investment is at odds with the analogous concept in international agreements in which the Republic of Kazakhstan participates and which, according to the Republic's Constitution, relate to the current Kazakhstani law and have priority over Kazakhstani laws.

Thus, the Agreement on the Encouragement and Mutual Protection of Capital Investment of 18 December 1992 between the Republic of Kazakhstan and the United States deems to be foreign investments (*i.e.*, those made by one state-participant in the Agreement on the territory of the other state-participant) any capital investment, made on the territory of one of the states, which is owned or directly/indirectly controlled by a citizen and company of the other state (Article 1). Also, the Agreement provides an extensive, if not exhaustive, list of specific forms of investments that roughly coincides with the list of the forms of general investments anticipated by the Law on Foreign

An analogous concept of foreign investment figures in the Agreement on Encouragement and Mutual Protection of Capital Investments between the Republic of Kazakhstan and the Federal Republic of Germany of 29 January 1993 (Article 1) in the Agreement on the Energy Charter (Article 1), as well as in many other international agreements.

Therefore, in working with all the investment relations anticipated by the above-mentioned Agreements, one should not apply the definition of "foreign investment" offered in the revised 1999 version of the Law on the Foreign Investment, but rather the one that is used in international agreements and that was previously included in the Law on Foreign Investment.

If one also takes into account the fact that the Law on Foreign Investment contains an imperative injunction – "All forms of a foreign investment ... are subject to conditions no less favorable than those that would apply under similar circumstances to investments ... made by any other foreign legal entity or private person" (Article 4) – then the broad interpretation of a foreign investment must apply to capital investments of foreign investors from countries that have not concluded special agreements or treaties on the mutual protection of capital investments with Kazakhstan.

Therefore, we firmly believe that the new definition of foreign investment must be excluded from the Law on Foreign Investment, as amended.

7. The 1997 Law on Governmental Support of Direct Investment

Alongside the norms that aggravate the legal situation for foreign investors with respect to certain types of investment, new legal conditions have appeared that are more lenient than those governing the usual types of investment. This is thanks to the new Law On the Governmental Support of Direct Investment of 28 February 1997. Articles 1 and 6 of this Law proclaim that they regulate relations that arise where the government exercises support for direct investment in priority sectors of the economy (the list of these sectors was approved by the President of the Republic of Kazakhstan). This is direct investment the goal of which is to introduce new technologies, to saturate the domestic market with quality goods and services, to create new jobs, to improve the natural environment, etc. (Article 5). The Law, for example, anticipates privileges in tax duties and customs duties as well as grants in kind for investors who have signed special agreements with an agency designated by the government (designated investor).

In accordance with the 1999 version of the Foreign Investment Law, and Article 3 of the 1997 Law mentioned herein, the legal regime of direct

investment is – where necessary – supplemented by the Law on Foreign Investment. This is quite significant, especially for determining the procedure for resolving investment-related disputes.

However, we believe that there are also several flawed definitions in the Law on Governmental Support of Direct Investment.

For instance, the term “direct investment” is imprecise and unclear. Traditionally, “direct” investment is distinguished from “portfolio” investment, the decisive factor being the range of the power and authority enjoyed by an investor. A direct investor acquires rights to govern the legal entities the shares of which he has acquired. A portfolio investor enjoys no such rights. A similar juxtaposition can be seen in the Law on Foreign Investment (Article 1 in the version of August 1999). The Law on Governmental Support of Direct Investment regards as direct investment those types of investment that an investor makes into the principal (charter) capital of a Kazakhstani legal entity with the exception of investments bound by official guarantees of the Republic of Kazakhstan and that are part of official technical support or grants provided to the Republic of Kazakhstan. Here, direct investments are not made a function of the possibility of managing investment projects and are not juxtaposed with portfolio investments. In the same Law of 28 February 1997, an investor who receives state support is defined as designated investor. By the nature of his distinctive characteristics, such an investor should – we believe – be more properly called a “priority investor.”

8. Perspectives for the Development of the Legislation on Foreign Investment

The program designed to attract direct investment to the Republic of Kazakhstan in the period of 1999-2000 (approved by a Decree of the Kazakhstani Republic Government of July 1999, No. 911)⁴ anticipates the development of the normative-legal basis to improve the investment climate in the Republic of Kazakhstan. The program has as its goals simplifying procedures for obtaining authorizations and permit credentials, providing for collaboration of the Republic of Kazakhstan with international arbitral organizations, simplifying customs procedures, etc. This tendency has been supported on several occasions by the Republic’s President. However, certain amendments have been proposed to the investment law by officials who do not agree with this direction in the development of investment law. For instance, at a meeting on investment-related issues in the capital Astana, Vice

4. *Sobranie Aktov Prezidenta Respubliki Kazakhstan i pravitel'stva Respubliki Kazakhstan* 1999 No. 32-33, 119.

President Utembaev pledged to nullify Article 6 of the Law on Foreign Investment, which outlines guarantees to protect foreign investors' interests against unfavorable changes in tax legislation.⁵

We suggest, therefore, that any further amendments meant to improve the Kazakhstani Law on Foreign Investment be approved only after the careful overall preparation of such suggestions, once they have been evaluated and considered in a balanced and qualified manner.

5. *Panorama* 28 January 2000 No. 4.