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RUSSIA

The Strategic Sectors Law and Its Impact on Foreign Investment in Russia

May 7, 2008 was an important day for foreign investors in Russia. Not only was Dmitry Medvedev inaugurated into office as President of the Russian Federation, but also the eagerly anticipated "Law on Foreign Investment in Companies with Strategic Significance for National Security and Defense" (the "Strategic Sectors Law") and Federal Law No. 58-FZ, amending certain other Russian laws to give effect to the Strategic Sectors Law (the "Amendments Law") came into effect.

The Strategic Sectors Law sets forth restrictions on foreign investment in certain sectors which the Russian Government considers to be of strategic importance to national security and defense. These sectors include the natural resources sector, aviation, defense, the media, communications and nuclear facilities among others. In total, 42 sectors are covered by the Strategic Sectors Law, making the list longer than anticipated. The implications of the

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UKRAINE

High Court Recommendation Potentially Weakens Rights of Foreign Shareholders in Ukrainian Companies

Ukrainian corporate legislation may be said to be evolving in the direction of European Union legislative norms. A number of draft legislative acts are currently being developed to establish more investor-friendly rules of corporate governance and offer better protection of shareholders' rights in Ukraine. Pending these reforms, foreign investors have tended to structure their corporate relations in Ukraine through shareholder agreements governed by

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KAZAKHSTAN

Draft Tax Code Proposes Wide-ranging Changes in Kazakhstan

In early 2008, the Government of Kazakhstan published a framework for a new Tax Code. According to the framework document, the general intention is that the new Tax Code will promote modernization and diversification of the economy and minimize the so-called "grey economy," under which taxes are evaded. The new Tax Code is intended to reduce the total taxation burden on non-extractive industries, with the fiscal shortfall being recouped by increased taxation on the resource sector. The new Tax Code is expected to enter into force on January 1, 2009.

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Strategic Sectors Law in Russia are broad and significant. Already several deals have been put on hold to await the establishment of the government body needed to approve investment. In the short term, this law will likely have a negative impact on deal flows in Russia while important legislation is enacted and new institutions are established to put the law into operation, but it is hoped that the law will finally clarify those sectors considered strategic for Russia and thereby create greater transparency for investors.

What are Strategic (and Strategic Subsoil) Companies?

The Strategic Sectors Law lists 42 sectors which the Russian Government considers to be of strategic importance. These include the construction of nuclear facilities, media-related activities such as television and radio broadcasting to more than half Russia's population, large-scale printing or publishing, activities relating to aviation and aircraft safety, and geological exploration and extraction of natural resources from subsoil plots of "*federal significance*". Any company engaged in any of the 42 listed activities is deemed to be a strategic company.

A strategic subsoil company is a strategic company engaged in activities on subsoil plots considered to be of "*federal significance*". As defined by the Strategic Sectors Law, subsoil plots of "*federal significance*" include those:

- containing deposits of uranium, diamonds, quartz of very high purity, rare-earth minerals of the yttrium group, nickel, cobalt, tantalum, niobium, beryllium, lithium, or metals of the platinum group;
- containing (according to information on the state balance of mineral reserves, commencing January 1, 2006):
 - recoverable reserves of oil of 70 million tons or more;
 - reserves of gas of 50 billion cubic meters or more;
 - vein gold reserves of 50 tons or more;
 - copper reserves of 500 thousand tons or more;
- lying within any inland sea waters, territorial sea waters, or the continental shelf of the Russian Federation; or
- situated in subsoil areas where the land is used for defense and security purposes.

Who is a Foreign Investor?

The Strategic Sectors Law applies to foreign investors seeking to invest (or in some cases already investing) in the 42 sectors

referred to above in Russia. The Strategic Sectors Law broadly defines a foreign investor as any non-resident of Russia who is capable of investing under the laws of the jurisdiction in which it is a resident. This includes entities, individuals, states and/or international organizations, as well as any company established in the Russian Federation operating under the "*control*" of foreign investor(s).

"Control" of a Strategic Company

The Strategic Sectors Law applies to proposed transactions which would result in a foreign investor controlling, directly or indirectly, a strategic company.

A foreign investor will be deemed to "*control*" (directly or indirectly) a strategic company if it has the right, in respect of the management of the strategic company, to appoint the sole executive body of the company, to form or engage a management company to oversee the functions of the executive body or to otherwise determine the decisions and business activity of the company. Furthermore, a foreign investor will be deemed to "*control*" a strategic company if it has the right, with respect to the equity of a strategic company, to dispose of more than 50% of the voting shares of the company (or less than 50% of the voting shares, if the distribution of votes enables such foreign investor to determine the decisions of the company), appoint more than 50% of the collective executive body, or elect more than 50% of the board of directors or other managing body of the company.

A lower control threshold applies to strategic subsoil companies. A foreign investor will be deemed to control a strategic subsoil company if it has the right to dispose of 10% or more of the voting shares of a strategic company, appoint 10% or more of the collective executive body, or elect 10% or more of the board of directors or other managing body of the company.

The implications of this law are major, given the number of Russian companies that are structured using foreign offshore holding companies. Accordingly, not only purely foreign entities will be affected, but also major Russian companies owned by Russian shareholders via offshore holding vehicles.

Transactions Covered by the Strategic Sectors Law

Any transaction (including offshore transactions) which would result in a foreign investor controlling (based on the

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criteria set out above) a strategic (or strategic subsoil) company will require the prior approval of the Government Commission for Control over Foreign Investment in Russia (the "Commission"). The Commission was established on June 2, 2008. Although the composition of the Commission has not yet been approved, it is already clear that Russian ex-President Vladimir Putin will head the Commission.

Approval must be obtained prior to conclusion of a transaction and will likely take up to three months, and in certain circumstances, even longer. Investors will need to build this approval process into their transaction timetables, in addition to other permissions, such as antimonopoly approvals.

Failure to acquire prior approval of the Commission, or a breach of any condition attached to approval, may result in the transaction being unwound. Courts could impose other restrictions, including limiting voting rights of the foreign investor in the strategic company.

Exemption from Requiring Prior Approval of the Commission

A transaction will not require prior approval from the Commission if the foreign investor has already gained the right to dispose of more than 50% of the voting shares of a strategic company (other than a strategic subsoil company) and, in respect of a transaction relating to a strategic subsoil company, if the Russian Government has the right to dispose of more than 50% of the voting shares of such company.

Grandfathering

The Strategic Sectors Law generally does not apply to transactions concluded before May 7, 2008. However, any foreign investor which held, on May 7, an interest (direct or indirect) of more than 5% of the voting shares or participation interest in a strategic company must notify as yet unspecified authority by November 6, 2008, regarding such interest.

Implications for Foreign Investors with Interests in Strategic Subsoil Companies

More severe restrictions are imposed on foreign investment in strategic subsoil companies. One such restriction is the possible prohibition on foreign investors (including Russian companies with foreign shareholders) being prohibited from participating in tenders and auctions for the right to use certain subsoil plots of federal significance. Another major issue which foreign investors who hold combined licenses may face is the possible loss of a combined license (covering

exploration and mining) if they discover a mineral deposit on a subsoil plot of federal significance after May 7. This should not apply if the geological study had been completed and prospecting and mining operations had commenced before May 7, 2008. However, this area of the law is rather vague, and thus its implications are not yet entirely clear.

In addition, the Russian Government has the power to refuse to grant mining subsoil licenses to strategic subsoil companies controlled by foreign investors on subsoil plots of federal significance.

Examples of the Impact on Other Sectors

The impact of the Strategic Sectors Law and the Amendment Law is far reaching. For example, mobile telephone service operators with more than 25% of the mobile market in Russia, and/or fixed-line operators¹ are considered to have a dominant position, and are therefore considered to be strategic companies. The law also will affect investment in various types of media, ensuring government control over foreign investment in this sector.

Conclusion

The Strategic Sectors Law finally clarifies those sectors which will be considered strategic to the Russian Government, and this is an important step in making the legal system for foreign investment in Russia more transparent. However, the Strategic Sectors Law covers a wide array of sectors, and the restrictions on the subsoil sector are very tight, making it very difficult and time-consuming to transfer assets in this sector. Also, in drafting a law without concurrently creating the necessary institutions, the Russian Government has strained the flow of necessary investment into Russia, while investors await further clarity. Finally, after so many years of deliberation by the Russian Government, it is disappointing that the Strategic Sectors Law contains so many ambiguities. The fear, of course, is that these ambiguities may be interpreted to the advantage of the Russian Government and to the disadvantage of the investor. /L. Brank, K. Withane, D. Litvinova

¹ Those which are operating in Moscow and St. Petersburg, and/or in five or more areas of the Russian Federation.

Structural Changes in the Russian Federal Government

Shortly after his inauguration as the new President of Russia, Dmitry Medvedev initiated a reform of the Government, changing its entire structure.

On May 12, 2008, the newly-elected Russian President signed Presidential Decree No. 724 ("Decree 724"), altering the structure of Russian executive power and providing for the redistribution of certain powers among the executive bodies. Ultimately, the changes in government structure may affect certain matters pertaining to doing business in Russia, such as licensing, antimonopoly controls and registrations.

Decree 724 preserves the three-tier system of executive bodies, consisting of the higher level of ministries with the authority to regulate certain areas; and the lower level of federal services, which exercise the functions of control and protection, and federal agencies, which provide state services. At the same time, Decree 724 redistributes power among the ministries and their responsibilities for different agencies and services. Some of the changes are unexpected, and some may trigger important practical consequences, requiring that the relevant requests and applications are filed with different state authorities, as well as possible delays in processing requests and applications while the bureaucracy is being adjusted to comply with the changes.

For instance, the Ministry of Justice has been made responsible for the registration of non-profit organizations, a role previously carried out by the Federal Registration Service, which has been placed under the control of the new Ministry of Economic Development and must be liquidated by October 1, 2008.

The Ministry of Economic Development and Trade (as it was previously referred to) has been renamed the Ministry of Economic Development and has been stripped of all regulatory responsibilities for trade. In addition to the Federal Registration Service, the Ministry has gained control over the Federal Service for State Statistics, the Federal Agency of the Cadastre of Immovables and the Federal Agency of Geodesy and Cartography. The two agencies though will need to be liquidated by October 1, 2008. The Federal Agency for the Management of Federal Property, already under the control of the Ministry, has obtained the functions of the Russian Fund of Federal Property, now abrogated, and changed its name to the Federal Agency for the Management of State Property. After October 1, 2008, the latter will also receive the powers of the

then-liquidated Federal Registration Service, the Federal Agency of the Cadastre of Immovables and the Federal Agency of Geodesics and Cartography.

The functions of the former Ministry of Economic Development and Trade with regard to the regulation of trade have been transferred to the Ministry of Industry and Energy. Meanwhile, the Ministry of Industry and Energy has lost its functions with regard to the regulation of energy, which passed to the separate, newly-created Ministry of Energy. Accordingly, the former Ministry of Industry and Energy has changed its name to the Ministry of Industry and Trade. The Federal Agency of Industry and the Federal Agency of Energy which were under its control have now been abrogated.

The Ministry of Agriculture has acquired from the former Ministry of Economic Development and Trade the powers to regulate land issues and control over the Federal Agency of Forestry and the Federal Agency of Fishing.

The Ministry of Culture and Mass Media has lost the last part of its name and the related functions, which have been transferred to the Ministry of Telecommunications and Mass Media. For these purposes, the Federal Information Technology Agency, the Federal Agency of Telecommunications and the Federal Service for the Supervision of Telecommunications and Mass Media have been subordinated to the Ministry of Telecommunications and Mass Media.

The Ministry of Culture now has only two bodies under its control: the Federal Archive Agency and the Federal Service for the Supervision of Compliance with the Law on Cultural Heritage.

Decree 724 transferred to the Ministry of Natural Resources regulatory functions in environmental protection, and the aforementioned Ministry has changed its name to the Ministry of Natural Resources and Ecology. Otherwise, the Ministry has gained control over the Federal Service for Hydrometeorology and Monitoring of the Environment, the Federal Service for Ecological, Technological and Nuclear Supervision and the Federal Subsoil Use Agency.

In terms of the Ministry of Public Health and Social Development, the Federal Agency for High-Tech Medical Care and the Federal Agency for Public Health and Social Development are to be liquidated with the latter to be transferred in part to the Federal Medical Biological Agency.

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The Federal Agency for CIS Affairs has been established under the control of the Foreign Ministry.

Decree 724 empowers ministers to issue mandatory orders to the heads of the subordinated federal agencies and federal services and suspend their decisions. /K. Osipov, A. Petrov

New Securities Market Regulation Sets Out New Framework for Selling Foreign Securities to Russian Investors

The Federal Service for Financial Markets of the Russian Federation ("FSFM") recently adopted two resolutions aimed at facilitating the sale of foreign securities to Russian investors, including qualified investors.

In accordance with FSFM Resolution No. 07-105/PZ-N, dated October 23, 2007, as amended on January 22, 2008 (the "FSFM Resolution"), the private sale of foreign securities is now allowed, provided that the sale of foreign securities is not qualified as a *placement*.¹ According to the FSFM Resolution, if foreign securities are qualified as "foreign securities" under the FSFM Resolution, they can be sold by a Russian-licensed broker/dealer to any Russian investor.²

The Resolution sets forth the criteria to qualify foreign financial instruments based on the corresponding codes: (i) ISIN (International Securities Identification Number - the international identification number of securities, the code which unambiguously identifies a certain security or any other financial instrument); and (ii) CFI (Classification of Financial Instruments - the code of classification of a financial instrument) in accordance with international standards ISO 6166 and ISO 10962. Foreign securities may be qualified as shares, depository receipts for shares, unit shares or shares of investment funds, depository receipts for unit shares or shares of investment funds, bonds and depository receipts for bonds. The Resolution specifies the documents which confirm the qualification of a foreign financial instrument as a security.

If foreign securities are not qualified as "foreign securities", they can be sold by a Russian-licensed broker/dealer to "qualified investors" only. FSFM Resolution No. 08-12/ps-n, dated March 18, 2008 ("Resolution No. 08-12/ps-n") and Article 51.2 of Federal Law No. 39-FZ "On the Securities Market", dated

April 22, 1996 as amended, defines who will be considered "qualified investors". Qualified investors are persons directly cited, as well as persons recognized as qualified investors in compliance with these legal acts. While some entities are already recognized as qualified investors (for example, banks), other legal entities and persons may only become recognized as qualified investors by completing an application and meeting certain requirements according to federal law in the procedure established by Resolution No. 08-12/ps-n. A person may be recognized as a qualified investor in respect of one or several kinds of securities and other financial instruments and one or several kinds of services intended for qualified investors.

Draft amendments to the Federal Law "On the Securities Market" are under consideration, which would simplify the process of selling foreign securities on the Russian market. We will provide an update on this issue when the amendments are passed. /V. Andrianov, D. Gubarev

Russia Clarifies Provision on Transactions Contradicting "Public Policy"

The Higher Arbitration Court of Russia (the "Court") recently considered the application of Article 169 of the RF Civil Code ("Article 169"), which stipulates that transactions that are deliberately contrary to "law, order and morality" ("Public Policy") are void, and grants the State the right to seize property involved in such transactions. On April 10, 2008, the

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- 1 A *placement* is considered the issuance of securities by the relevant issuer to its shareholders.
- 2 At present, direct *public* sale (*i.e.*, circulation on stock exchanges or by offering securities to an unlimited number of persons) of foreign securities to Russian investors does not appear to be possible. Securities issued by foreign issuers (except for securities issued by international financial organizations) may be authorized for placement or public circulation in Russia only based on (i) an international treaty to which Russia is a party, or (ii) a bilateral interagency agreement between the FSFM and a similar state agency of the country where the issuer of securities is incorporated. Interagency agreements exist between Russia and the following jurisdictions: Belarus, Brazil and the unrecognized Republic of Pridnestrovie (officially part of the Republic of Moldova). According to the FSFM, the latter two agreements exist, however the text of these agreements is not publicly available, and they may be subject to restrictions.

Court issued Resolution 22, which clarifies how the courts may interpret and apply the provisions of Article 169.

According to Resolution 22, Article 169 applies to transactions that fail to comply not only with the rules set forth in law, but also the principles of social, political and economic organization of society, and its moral foundations. Such transactions may include transactions directed at the production or purchase of weapons, ammunition, narcotics or other items dangerous to human life or health, production or distribution of literature or other forms of propaganda emphasizing ethnic, racial or religious hostility, or the production or sale of counterfeit documents and securities.

Under the terms of Resolution 22, the Court emphasized that in order to apply Article 169, declare a transaction void and grant the seizure of property involved in such a transaction, a court must determine that the goal of the transaction is deliberately contrary to the fundamentals of Public Policy.

The goal would be so designated if at least one of the parties was deemed to have a malicious intent. It is noteworthy that according to Article 169, where a transaction is declared void because its goal qualifies as contradicting to the Public Policy, the seizure will not apply to a party which entered into the transaction without any malicious intent. Accordingly, where a transaction is declared void under Article 169, a party acting without malicious intent will still be entitled to receive back any property delivered to the party acting with malicious intent, although any property received from the latter will be subject to seizure by the State. Resolution 22 further stipulates that the remedies set forth in Article 169 must not be applied only in part. As a result, if a plaintiff makes a valid request that the court only seize the property of a defendant acting with malicious intent, the court must not only satisfy the plaintiff's specific request, but also rescind the transaction and ensure that the property belonging to the party acting without malicious intent is returned.

Where, prior to commencing bankruptcy proceedings or in the course of such proceedings, a company enters into transactions which worsen the debtor's position (such as an interested-party transaction, according to which preferential treatment is extended to certain creditors), Resolution 22 further provides that the mere fact of entering into such transactions will not render the transactions void within the meaning of Article 169. The Court emphasized that any such application of the remedies set forth in Article 169 and, in particular, the seizure of property by the State, would adversely affect the interests of creditors. In this respect, Resolution 22 appears to be favorable to creditors, who even

if able to rescind questionable transactions by a bankrupt debtor, would not otherwise enjoy the benefit of the increase in value of the debtor's assets available for satisfaction of creditors' claims, since the property in question would have been seized by the State.

Where the courts resolve administrative, tax or other disputes arising out of legal relationships between private entities and the public authorities, and a transaction constitutes an offense under public law, or such offense is connected with the transaction, the sanctions set forth for violation of the relevant public law will apply, not those set forth in Article 169.

The Court confirmed that tax authorities may bring claims challenging the validity of transactions. At the same time, the Court ruled that they can do so only to the extent that satisfying such claims would fulfill the tax authorities' objectives as set forth in applicable law. Attempting to seize property based on Article 169 when alleging that a transaction was conducted for tax evasion purposes, is not permitted. Such remedy is beyond the scope of authority of Russian tax authorities, since an Article 169 seizure is not a measure aimed at ensuring the collection of taxes. In such circumstances, Resolution 22 explicitly suggests that the tax authorities may instead have recourse to Article 170 of the RF Civil Code, which relates to sham and fictitious transactions.

To sum up, Resolution 22 addresses one of the most sensitive and disputed areas of the application of Article 169, namely tax disputes. Resolution 22 attempts to draw a clear distinction between relations between private entities on the one hand, and relations between private and public entities on the other hand. As a result, it may significantly help to promote greater stability in the business environment in Russia. /K. Osipov, A. Petrov

Russia Reshapes Its Gambling Industry

Until recently, gambling in Russia was barely regulated, allowing for almost unrestricted development of gambling sites anywhere on Russian territory. This changed in December of 2006, when new legislation¹ provided for much

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¹ Federal Law No. 244-FZ, "On the State Regulation of Activities Related to the Organization and Arrangement of Gambling and on Making Amendments to Some Legislative Acts of the Russian Federation", dated December 29, 2006.

stricter regulation of gambling, necessitated by an exceedingly large number of gambling sites all over Russia - from slot machines in grocery stores to lavish casinos in almost every major city.

When the new legislation took effect in July 2007, it led to the prompt closure of many gambling sites that did not comply with the stricter requirements of the new law, specifically forbidding free-standing slot machines and stipulating that gambling might only take place on premises in compliance with design and safety requirements, and most importantly, might only be organized by legal entities with a net asset value exceeding (i) RUB600 million for casinos and slot machine operators, and (ii) RUB100 million for bookmakers. In addition, the new law prohibited all gambling via the Internet or any telecommunications networks on the territory of the Russian Federation.

However, the most significant provision of the new law, which takes effect on June 30, 2009, would completely ban all organized gambling on the territory of the Russian Federation, except in four newly-created "gambling zones". A "gambling zone" (the boundaries of which are set forth in applicable law) is defined as a part of the territory of the Russian Federation which is designated for organizing and holding risk-based events with an uncertain outcome. Gambling zones are being created in four administrative districts: Altayskiy Kray, Primorskiy Kray, Kaliningrad Oblast, and jointly in Krasnodarskiy Kray and Rostov Oblast. In each of these four administrative districts, only one gambling zone may be created. The management and regulation of the gambling zones falls within the jurisdiction of the local authorities, whose powers will include issuing gambling licenses and allocating (by means of sale into ownership or leasing) land plots within the gambling zone for the construction of gambling and other infrastructure by private investors.

To support the relocation of all organized gambling into the newly created gambling zones, the Russian government has pledged to invest over US\$4 billion to develop roads, pipelines and other basic infrastructure, with the view that it will provide the necessary incentive for private companies to invest in the construction of hotels and casinos. Architectural and designer projects for gambling zones have already been submitted for review to the federal government, which will determine how much financing from the federal budget the local authorities will receive.

There is a clear intention on the part of Russian authorities to

make gambling more regulated and organized, and the creation of "Russian Las Vegas" may provide lucrative opportunities for investors. But until more detailed regulations with respect to licensing and allocating property within the designated gambling zones are adopted, it remains to be seen how successful this major transformation in the industry will be.

In the meantime, hotel operators and shop owners will need to ensure that activities carried out on their premises do not infringe the new law. /K. Skopchevskiy

Update on Joint Implementation Projects in Russia

Russian environmental law has recently opened the door to Joint Implementation ("JI") projects in Russia. This provides a wave of new opportunities for investors in Russia, with Russia being widely recognized as potentially the largest host country of JI projects. New Russian President Medvedev has already expressed a keen awareness of the environment's role in shaping the Russian economy. At a meeting of the Security Council held in January of 2008, President Dmitry Medvedev said, "...In the coming years the quality of the environment will be a key factor in the competitiveness of each Russian region and that of the entire country, not to mention the significant impact these factors have on the demographic situation and the health of the nation."

Last year Russia took a major step towards further mitigating the effects of climate change, when Resolution No. 332 of the RF Government "On the approval and supervision of the realization of JI projects" (the "JI Procedures") was adopted. It sets out the first set of procedures to approve JI projects in Russia in connection with Article 6 of the Kyoto Protocol. The JI Procedures are universal in that they relate to both Track 1 and Track 2, also establishing (i) the procedure to submit JI project realization reports to a commission (the "JI Commission") at the Ministry of Economic Development ("MED"), which acts as Russia's designated focal point (contact point) for JI projects, and (ii) rules relating to the approval or removal of JI projects from the approved list of JI projects. The JI Commission held its first session in February this year, when it decided to start considering JI projects on March 10, 2008.

Currently, the JI Commission is considering ten JI project

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applications (while two additional JI projects await registration with the JI Commission), but, as of the date of this article's publication, none have been approved. Recent reshuffling and structural changes to the Russian Government may mean additional delays in the approval (and registration) process, and in Russia being granted initial eligibility status under the Kyoto Protocol (currently envisaged to occur on June 20, 2008). Nevertheless, foreign investors interested in undertaking JI projects in Russia might take comfort in other positive signs. For example, a list of independent firms permitted to verify Emissions Reduction Units ("ERUs", the units that can be traded on the global carbon market) in Russia was approved in March 2008 (although the list has not entered into force yet), and the Russian registry, although not yet operational, has completed the initialization process and was successfully connected to the International Transactions Log (ITL) of the Kyoto Protocol on October 3, 2007.

The initial national limit for JI projects was agreed by federal ministries at the volume of 300 million metric tons of carbon dioxide ("CO₂")-equivalent. Even with the restrictions, Deputy Minister of the Economy Vsevolod Gavrilov is reported to have mentioned at a press conference that he expects JI projects to achieve cuts of 100-500 million metric tons of CO₂ by 2012, equaling 100-500 million ERUs. The majority of ERUs (approximately 70%) were allotted to the energy sector, however, according to a recent MED statement, some ERU quota allocations to certain sectors (e.g., land tenure, agriculture and forestry) may be redistributed to other sectors.

Russian legislation for CO₂ emissions trading in Russia has yet to be adopted. Similarly, legislation relating to the third flexible mechanism under the Kyoto Protocol, the Clean Development Mechanism ("CDM"), has not yet been adopted in Russia. MED has very recently stated that it is unlikely that emissions trading and CDM projects will occur in Russia for the next five years. /F. Mucklow, V. Andrianov, R. Mikhailov

UKRAINE

High Court Recommendation Potentially Weakens Rights of Foreign Shareholders in Ukrainian Companies

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the law of England and Wales, Delaware, or some other non-Ukrainian jurisdiction. However, the rights of shareholders, including foreign investors, were potentially weakened in Ukraine on December 28, 2007, when the High Commercial Court of Ukraine (the "High Court") issued a Recommendation - No.04-5/14 "Regarding Practice of Application of Legislation During Consideration of Cases Arising Out of Corporate Relations" (the "Recommendation"). This article outlines the most important implications of the Recommendation for foreign shareholders in Ukrainian companies.

The High Court purportedly issued the Recommendation to harmonize commercial court practice, and circulated it to all Ukrainian commercial courts. Yet certain provisions in the Recommendation are at variance with the provisions of existing Ukrainian legislation, such as the laws "On Private International Law," "On Regime of Foreign Investments," "On International Commercial Arbitration," the Civil Code of Ukraine, and the Code of Commercial Procedure.

Perhaps of greatest concern to foreign investors is the last section of the Recommendation, which relates to corporate governance and the protection of shareholder rights. Among other things, according to this section: (i) shareholder agreements governed by a law other than Ukrainian law are *a priori* null and void; and (ii) shareholders in Ukrainian companies cannot have recourse to international commercial arbitration to resolve any dispute that may arise. By contrast, the Recommendation may offer protection to Ukrainian shareholders.

Although the Recommendation is not binding upon Ukrainian commercial courts (it functions more as a guideline), the mere fact that the High Commercial Court of Ukraine (one of the highest judicial bodies in Ukraine) issued it, creates a risk that Ukrainian commercial courts will follow the Recommendation and create a less attractive

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investment climate for foreign investors.

Both Western investors in Ukraine and Ukrainian legal experts have heavily criticized the Recommendation and have lobbied Ukrainian state authorities to amend or withdraw it. It is hoped that the authorities will yield to this request.

In the meantime, the Recommendation remains valid and any attempt by a Western investor to enforce international arbitration awards arising out of shareholder agreements in Ukraine, in particular, on the basis of the 1958 New York Convention on the Recognition and Enforcement of Arbitration Awards, may prove unsuccessful. However, Western shareholders in Ukrainian companies who have signed shareholder agreements governed by the laws of non-Ukrainian jurisdictions may still be able to enforce such agreements outside of Ukraine, to the extent that either the Ukrainian companies in question or their Ukrainian shareholders hold assets abroad. /O. Akhtyrskiy

National Registry and a Free Carbon Market are Key to Joint Implementation Projects in Ukraine

Since ratifying the Kyoto Protocol on 16 February 2005,¹ Ukraine has begun introducing legislation that should make it increasingly attractive as a host for Joint Implementation (JI) projects,² with a view to continuing to reduce its carbon emissions well below its Protocol commitments. This article briefly sets out the background to emissions trading legislation under the Kyoto Protocol, the status of such legislation in Ukraine, and the legislative steps still required to enable Ukraine to trade in carbon emissions under the Kyoto Protocol.

Emissions Trading

Countries with commitments under the Kyoto Protocol (Annex B Parties), including Ukraine, have accepted individual targets for limiting or reducing emissions. These targets are expressed as levels of emissions permitted, or “assigned amounts,” over the 2008-2012 commitment period. The “assigned amounts” are divided into “assigned amount units,” or AAUs.

Emissions trading, as set out in Article 17 of the Kyoto Protocol, allows countries with spare AAUs to sell this unused

capacity to countries that are exceeding their emission targets. Since carbon dioxide is the principal greenhouse gas, carbon is now traded like any other commodity. Conversely, it is also possible to transfer reductions of greenhouse gases. These reductions are measured in emission reduction units (ERUs), where each ERU represents a reduction of one metric ton of CO₂ or equivalent.

As stipulated in the Protocol, an international transaction log ensures secure transfer of ERUs between countries. Under JI, a country can earn ERUs, which count towards meeting its Kyoto target, from an emission reduction or emission removal project that occurs in another country, provided that both countries involved are Annex B Parties.

As a result, JI offers countries a flexible and cost-efficient means of working towards their Kyoto commitments, and for any host country, the benefits of foreign investment and technology transfer.

Status in Ukraine

Since Ukraine has not fulfilled all the required conditions of the Kyoto Protocol to enable it to participate in Track 1 of the JI mechanism and thereby approve projects independently, Ukrainian JI projects must still comply with the lengthier Track 2 approval process conducted by the UNFCCC Secretariat.³

So that Ukraine can qualify for Track 1, draft legislation to establish the National Greenhouse Gas Registry (the Registry) has been prepared, and it is hoped that it will be both submitted to, and approved by, the Cabinet of Ministers in the next few months. According to the Head of the National Environmental Investment Agency,⁴ the Registry will be fully operational by the end of 2008, at which point Ukraine will qualify for Track 1.

However, two recent legal developments may affect the potential volume of trading.

First, on January 30, 2008, the Ukrainian government passed a resolution setting minimum prices for carbon

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1 Law of Ukraine on Ratification of the Kyoto Protocol to the United Nations Framework Convention on Climate Change N 1430-IV dated February 4, 2004.

2 A mechanism defined by Article 6 of the Kyoto Protocol.

3 UNFCCC: United Nations Framework Convention on Climate Change.

4 <http://www.neia.gov.ua> - Official homepage of the National Environmental Investment Agency.

credits generated in Ukraine.⁵ Fortunately for the prospects of JI in Ukraine, the resolution was repealed, because the application of minimum prices to AAUs and ERUs might have jeopardized the validity and enforceability of emission reduction purchase agreements that had already been signed.

Second, on April 17, 2008, the Ukrainian government passed a resolution stipulating that emission reduction purchase agreements signed by the National Environmental Investment Agency must be approved in advance by the Ministries of Economy and Finance and then the Cabinet of Ministers of Ukraine.⁶ Before this resolution was passed, no governmental approval was required prior to the signing of such agreements, apart from the National Environmental Investment Agency approval for project documentation.

Power, gas, and carbon market analysts Point Carbon⁷ estimate that Ukraine's carbon market could attract EUR3.6 billion of investment in 2008-2012. However, for this to happen, the Registry must become operational soon, the Ukrainian government must allow AAUs and ERUs to be transferred at market rates, and the approval regime for emission reduction purchase agreements must not have a deterrent effect. */V. Dovhan*

⁵ Cabinet of Ministers Resolution # 27 was in force only from January 30, 2008 to April 17, 2008.

⁶ Cabinet of Ministers Resolution # 392 dated April 17, 2008.

⁷ <http://www.pointcarbon.com>.

KAZAKHSTAN

Draft Tax Code Proposes Wide-ranging Changes in Kazakhstan

(Continued from page 1)

In anticipation of the new Tax Code, Prime Minister Karim Masimov has ordered the suspension of all negotiations with foreign investors on exploiting Kazakhstan mineral and hydrocarbon deposits. It remains to be seen whether the Government will maintain this position in light of the continuing international interest in Kazakhstan's natural resources and high global energy prices. The Prime Minister has also confirmed that all existing contracts will be honored by the Kazakhstan side, so long as foreign investors fulfill all their contractual obligations.

The framework document stipulates that the new Tax Code will contain reforms of most taxes and special tax regimes, as well as improvements to tax administration procedures. In particular, the following taxes will be affected: corporate income tax, value added tax, special tax regimes for small businesses, special tax regimes for agricultural producers, individual income tax, social tax, property tax and excise duties. In the remainder of this article, we focus on those changes most likely to be of interest to investors.

Corporate Income Tax. At this stage it appears that the most significant changes will be to corporate income tax. The main area of reform will be to simplify the calculation of taxes and eliminate some existing benefits. The current CIT rate of 30% is expected to be reduced to 20%. 77 types of tax benefits (out of the current 170) will be removed, including those currently applicable to:

- oil producers (exemption from CIT for up to 10 years);
- high added value production (reduction of CIT rate to 20% under certain specified conditions);
- stock exchange transactions (exemption from capital gains tax on the sale of securities, payment of interest and dividends);
- leasing companies (exemption of lease fee earnings);
- payments made by investment funds (exemption of dividends paid to shareholders of investment funds); and
- insurance companies (CIT rates of 1-4% applicable to income from premiums only).

The framework document also proposes amending fifteen different types of tax benefits, including investment tax benefits, the tax regime applied in special economic zones, and the special tax regimes for small businesses and agricultural producers.

Mineral Extraction Tax. Another significant change in the framework document concerns the introduction of a new mineral extraction tax in place of the export rent tax currently applicable to subsoil users. The export rent tax was originally designed to tax excess profits of subsoil users. According to the Kazakhstan tax authorities, this tax has not been as effective as was expected. The new tax will make tax calculation and administration easier, and the resultant revenues will depend not on the taxpayer's profits but rather on the world prices of raw materials.

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Other changes. Other changes being considered are whether to at least double excise duties on alcohol and tobacco products, as well to increase the tax rate applicable to high-value real estate.

According to Minister of Finance Bolat Zhamishev, in 2007, the state collected KZT2.8 trillion (approximately US\$23.5 billion) in taxes, including KZT564 billion (approximately US\$4.7 billion) of tax-related penalties and fines. Kazakhstan's GDP for 2007 was KZT12.726 trillion (approximately US\$106.8 billion), according to statistics published by the National Bank of the Republic of Kazakhstan. /L. *Madieva*

Kazakhstan Introduces New State Procurement Law

The Kazakhstan Government has introduced a new State Procurement Law¹ that narrows the definition of customers acquiring goods and services and increases the categories of customers that may be exempt from application of the rules.

The new law – which came into force on January 1, 2008 – now applies to companies in which the State owns more than a 50% interest (“State Majority Company”), as well as to affiliates of such companies (companies directly or indirectly owned by a State Majority Company). As a result, the law no longer applies to 50/50 joint venture companies where the State is directly or indirectly a participant.

In addition, the State Procurement Law provides for more exemptions than previously. A company otherwise subject to state procurement rules may be exempt if it is acquiring:

- (i) rights to use natural resources;
- (ii) raw materials not produced in Kazakhstan and acquired abroad by strategically significant manufacturers (as per a list to be approved by the Government);
- (iii) securities and shares in the charter capital of legal entities;
- (iv) goods or services on the basis of international agreements to which Kazakhstan is a party (in accordance with a Government-approved list), or within the framework of investment projects funded by international organizations of which Kazakhstan is a member;

¹ Law of the Republic of Kazakhstan “On state procurement” No. 303-III, dated July 21, 2007

- (v) goods or services for the purpose of investing in the charter capital of legal entities;
- (vi) natural gas, uranium or their by-products, and the company is a State Majority Company or an affiliate thereof; and
- (vii) any goods or services, and the company is a State Majority Company or an affiliate thereof, and has received a specific corporate governance rating from a Government-approved rating agency.

In particular, these changes will streamline the procurement process for joint ventures that were previously under an onerous regulatory burden when seeking to obtain goods or services. /A. *Yermekova*

Kazakhstan Simplifies Work Permit Regulations

Recent amendments to the rules governing quotas and work permits for foreign employees in Kazakhstan came into force on June 1, 2008. The effect of the amendments is to increase the number of categories of foreign employees exempt from the permit regime, and to remove some of the more bureaucratic procedures previously involved in the process of obtaining permits.

The amendments were made to the Rules on Defining Quotas, Conditions and Procedures for the Issuing of Authorizations to Employers for Engaging Foreign Labor in the Republic of Kazakhstan (the “Rules”), pursuant to the Law of the Republic of Kazakhstan “On Employment” of January 23, 2001 and Government Decree No. 836 on the implementation of that law, of June 19, 2001.

The most significant change is that employers applying for permits no longer must submit a list of expatriate employees for approval after the permits themselves have been approved. The effect of this change is to streamline the process. The Rules also now include a points system for categorizing expatriate employees on the basis of their level of education, their experience, and the demand for their specialization in Kazakhstan. This change brings Kazakhstan closer to international practice in this area.

Also worthy of note is that the Rules now reflect the provisions of the Labor Code, under which persons working

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within the RFCA (Regional Financial Center of Almaty) will neither have to hold work permits nor be subject to quotas. RFCA employers now only need to notify the local Department of Labor every quarter on the number of expatriates they currently employ.

Kazakhstan's work permit regime has in the past been seen to be complex and arbitrary. Hopefully, these amendments will make the application and approval process more transparent and efficient. /A. Neovius, A. Yerzhumanova

Kazakhstan Imposing New Export Duty on Crude Oil

Starting from May 18, 2008, Kazakhstan is imposing a new export duty of US\$109.91 per metric ton on exports of crude oil by certain companies. The Kazakhstan Ministry of Finance published on May 16 a list of 38 companies that would be affected by the duty, including KazMunaiGas E&P. A similar duty on minerals exports is under discussion and may be imposed by the end of this year. Most large oil producers working under production sharing agreements are currently exempt from the duty, but comments in June by Prime Minister Karim Masimov indicate that, starting from next year, the duty is likely to apply to all subsoil users unless their contracts are ratified by the Parliament. /A. Neovius

RECENT DEVELOPMENTS

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The Chambers Europe - Europe's Leading Lawyers for Business 2008 guide recognized Chadbourne & Parke's Russia, CIS and Central Europe Practice. All four Moscow partners, the Managing Partner of our Kyiv office, and three of our counsel – including two in St. Petersburg – were ranked as leading lawyers in their respective practice areas, along with five of our Warsaw attorneys. Areas ranked included Banking & Finance, Capital Markets, Corporate/Commercial, Corporate/M&A, Dispute Resolution, Energy & Natural Resources, Energy & Natural Resources: Mining, General Business Law: St. Petersburg, and Private Equity, Projects, Real Estate, Tax, and The Central Asian Element.

CIS LEGAL NEWSWIRE

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