Private Investment Funds in Mongolia: Legal Framework

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1. INTRODUCTION OF NEW LEGAL FRAMEWORK

Mongolia has been trying to flourish and enhance its "dormant" capital market for the last several years. One of the key focus areas of improvement was the legal framework. As an initial step, Mongolia revised its Securities Market Law on May 24, 2013. After revising this main framework law for the securities market, Mongolia then adopted a new Law on Investment Funds on October 3, 2013 and that law entered into force on January 1, 2014. This new law was the first comprehensive law aimed at regulating investment funds (both mutual and private investment funds) in Mongolia. However, notwithstanding the significant improvement of the legal framework and legislation, recent data shows that the activities of private investment funds still have no growth.[1]

2. PRIVATE INVESTMENT FUNDS IN MONGOLIA

In general, Mongolia has formulated a relatively flexible and liberal legal framework for the activities of private investment funds, except for certain practical and uncertainty issues. These issues will be analyzed under the relevant subsections below. However, as the capital market is a new sector for Mongolia, there were no court cases available as of March 2017. Even if there is a single case, it will not have any effects for further court cases. This is because "precedent" is not considered to be a source of law in Mongolia, and the courts in the modern Mongolian legal system play no formal role in law creation. "In Mongolia, judges are only to apply law, not create it. Decisions issued by the various courts do not have precedential value, and there is no concept of *stare decisis*. Whilst judicial decisions of the Supreme Court are binding upon all courts and other persons for the particular purpose of that case, they have no further effect on legislation".[2]

2.1 Definition and professional investor

Private funds are broadly defined as "investment funds authorized to raise funds based on contractual arrangements by way of offering unit rights to professional

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[1] Market capitalization is 5% of total GDP, comparing to the world's average of rate of 97.403%. *Market capitalization of listed domestic companies (% of GDP),* the World Bank, http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS ; *The Financial Regulatory Commission's Financial Market Bulletin, Q3, 2016,* The Financial Regulatory Commission, *http://www.frc.mn/data/show/5399* ; *See also* V. Dangaasuren, *Capital Market Development in Mongolia,* The Northeast Asian Economic Review Vol. 3, No. 2, October 2015, http://www.erina.or.jp/wp-content/uploads/2015/11/naer32-2_tssc.pdf.

[2] Chris Melville, Erdenedalai Odkhuu and Anthony Woolley, *Overview of the Mongolian Legal System and the Law*, New York University Hauser Global Law School Program, Sep. 2015, http://www.nyulawglobal.org/globalex/Mongolia_Research.html.

investors".[3] Therefore, it appears that any funds, which are not considered as "mutual funds",[4] will be categorized under the term of "private investment funds", because Mongolian law recognizes only two types of funds. A mutual fund is a licensed activity and this article will not concentrate on mutual funds.

"Professional investor"[5] refers to persons that are considered as entities engaged in professional investment activity by law or the FRC,[6] such as investment funds, pension funds, banks or persons licensed to undertake activities related to non-banking financial activities, insurance, underwriting or dealer activities.[7]

Thus, since private funds may offer their "unit rights"[8] only to professional investors and the circle of professional investors is currently relatively small in Mongolia, this definition of a professional investor may limit the operation of private investment funds.

More importantly, it gives the FRC broad authority and discretion to decide who should be considered a professional investor. It therefore authorizes the FRC's involvement and sole discretion for the establishment and operation of private investment funds. The better approach would be carving out such discretion. Any investors, who are not conducting professional investment activities (such as investment funds, pension funds, banks or persons licensed to undertake activities related to non-banking financial activities, insurance, underwriting or dealer activities), should have the right to invest into private funds, as long as they satisfy certain pre-determined requirements, rather than FRC's sole and uncertain post-investment discretion. Therefore, it is highly recommendable that Mongolia should introduce written requirements for such investors who are not conducting professional investment activities. For example, such requirements can relate to an investor's net worth, or annual income, or assets similar to the requirements used in other jurisdictions. For instance, the concepts and requirements under "accredited investor",[9] or "qualified purchaser",[10] or "qualified clients"[11] under US legislation could be good examples.

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[3] Investment Fund Law, Art. 4.1.3., State Gazette, 2013, No. 41.

[4] "Mutual funds" are defined as "investment funds authorized to raise funds by way of offering unit rights through public offer (to more than 50 persons) in accordance with the Securities Market Law of Mongolia. *supra* note 3, Art. 4.1.2.

[5] The literal translation of the statutory term is "entity engaged in professional investment activity". *infra* note 7, Art. 4.1.9.

[6] Financial Regulatory Commission (FRC) is the Mongolian financial regulatory authority responsible for supervision of all non-bank financial services including securities market, insurance and activities of NBFI and Credit and Saving Unions. *see* Law on Legal Status of the Financial Regulatory Commission, State Gazette 2005, No. 46.

[7] Securities Market law, Art. 4.1.19, State Gazette, 2013, No. 24

[8] "Unit rights" means bearer security which certifies ownership right of the investor to the assets invested in the investment fund. *supra* note 3, Art. 4.1.7.

[9] "Accredited investor" is defined in Rule 501 of Regulation D. The requirements include: net worth of more than $1 Million; individual annual income of more than $ 200,000; or joint (spouse) annual income of more than $300,000 etc., 17 C.F.R. §230.501 (2016).

[10] "Qualified purchaser" is defined in 2(a)51 of the Investment Company Act of 1940. The requirements include: individual or family owned company with $ 5 Million (does not include house) etc., sec., 15 U.S. Code § 80a–2 (2012).

[11] "Qualified client" is defined in Rule 205(3) under the Investment Advisors Act of 1940. The requirements include: natural person (together with spouse) or company that has more than $ 1 Million under management with advisor; or has net worth of more than $ 2.1 Million; or "qualified purchaser" etc., 17 CFR 275.205-3 (2016).

2.2 Type and Investment Strategy

One might consider whether private investment funds under Mongolian law include commonly used fund types such as "private equity fund", "hedge fund", and/or "venture capital". In general, these funds are not strictly defined in international practice. Instead, they differ from each other by their investment strategies, investment lock-up period and/or investor's withdrawal requirements. Some funds even have mixed or hybrid features. In Mongolia, it appears that private investment funds can be established in any of these types because of flexible regulations and freedom to contractual arrangements.

For example, one of the key differences between these funds relate to the investment lock-up period, and, under Mongolian law, the investors and fund managers are free to choose any time period. The law authorizes that private investment funds could be established for a period of up to 10 years.[12]

In addition, another key difference relates to the investor's withdrawal rights. In Mongolia, the fund has the right to set out the relevant conditions and requirements. The law authorizes the fund to choose among (i) an investor's immediate termination right; (ii) an investor's termination right within certain time period; and (iii) an investor's obligation not to terminate before the termination of asset management agreement.[13] However, such condition must be clearly promulgated in the fund's internal asset management regulation.

However, from the perspective of investment strategy, it appears that Mongolia lacks investment options. First, instead of a flexible and unlimited investment strategy that could be determined by the fund manager, the law provides the enumerated list of investment instruments and private investment funds could only invest within such listed instruments. These include[14]: (i) government debt instruments; (ii) local government debt instruments; (iii) shares in listed companies; (iv) corporate debt instruments that are listed and being traded on a regulated market; (v) asset-backed securities;[15] (vi) shares in closed joint stock companies and limited liability companies; (vii) corporate debt instruments that are not traded on a regulated market; (viii) securities issued by foreign governments; (ix) derivative financial instruments; (x) foreign and national currencies; (xi) gold and other tradable mineral products; and (xii) immovable property, and the possession rights relating thereto. This list could cover most of the investment methods used by the private funds, but limiting the private fund's investment to only the enumerated list of investment instruments seems an over-protective measure.

Second, the FRC will issue net asset ratio requirements for the investment funds and because of the vague meaning, it is not clear whether private equity funds would be subject to such ratio requirements. If such requirements will be applicable for private

[12] *Supra* note 3, Art. 10.
[13] *Id.* Art. 25.2.
[14] *Id.* Art. 26.1.
[15] To the extent these are issued in accordance with the *Law of Mongolia on Asset-Backed Securities* enacted on 23 April 2010. *supra* note 3, Art. 26.1.8.

funds, it would be another burden for the private funds to freely choose their investment strategy and portfolio.

Thus, from the perspective of investment strategy, it appears that setting up and managing a classical "hedge fund" could be more difficult or not fully operative compared to a "venture capital fund" and "private equity fund". A venture capital fund's main investment strategy is investing into start-up companies via obtaining shares or convertible preferred shares or convertible debts. These are included in the enumerated list and therefore should not be an issue to setting up and managing venture capital funds. A private equity fund has the broad investment strategy of investing into all possible investments. It usually has a long-term investment purpose, so most of the investments may fall into the scope of the enumerated lists of investment instruments. As such, setting up and managing "private equity" type of funds would not be issue as well.

Hedge funds have become more similar to private equity funds. Hedge funds invest into various possible investments, but it may differ from private equity funds only by its short-term investment lock-up period and short-term investment purposes. Therefore, hedge funds have a more aggressive and sophisticated investment strategy. For example, direct lending, short/long sales, arbitrage, distressed, futures, emerging market, global macro, funds of funds etc., are commonly used investment strategies of hedge funds.[16] These investment instruments are neither included in the enumerated list, nor well developed in Mongolia. Therefore, setting up and managing the hedge fund type of fund would be possible, but it will not be fully operative as the Mongolian capital market has not yet developed to offer various investment products required by average hedge funds in other jurisdictions.

2.3 **Management fee and performance bonus**

Mongolian law recognizes the internationally-used "2/20" principle. The annual management fee can be up to 3% of the average net asset value of the fund. First, it actually refers to the "management service cost" instead of the management fee, so the term should be understood "broader" than the typical concept of a management fee. Second, it is not exactly certain what would constitute the average net asset value of the fund and whether the FRC will issue specific regulation on the calculation of the same. It is obviously not "committed capital", so it would be more similar to "invested capital". In addition, this cap of 3% must include custodian fees. Therefore, the total cost of the management fee and custodian fee may not exceed 3%.[17]

In the case of private funds, in addition to the management fee, investment management companies may also levy a performance bonus depending on the investment results, the annual rate of which should not exceed 30% of the total net profit of the fund. In other words, the fund manager could earn a 30% "carry". This must be reflected in the agreement between fund and fund manager. There are no further requirements with

[16] Stephanie R. Breslow et al., Hedge Funds: Formation, Operation and Regulation 85-133 (2016).
[17] *Supra* note 3, Art. 28.

respect to the carry, so parties could further agree to include "carry hurdle"[18] and/or "carry timing"[19] arrangements.

In some countries, including the US, private funds could charge additional fees upon prior disclosures or agreements with the fund investors. These could include a "monitoring fee", a fee for managing portfolio companies under a monitoring type of agreement, and a "transaction fee", a project specific fee in relation to big transactions. However, private investment funds in Mongolia are prohibited from charging any additional fee beyond 3% of the management fee (management service cost) and 30% carried interest (performance fee).[20]

2.4 Fund structure and LLC requirement

Private funds are usually structured in the form of a limited liability partnership (LLP) in the US and other countries. The main reason relates to the tax benefits and tax arrangements. In addition, well established principles and concepts in relation to the limited partnership under the agency and partnership laws might be ideal and straightforward in common law jurisdictions (specifically in Delaware).

Under Mongolian law, private funds must be organized as special-purpose companies (SPV)[21] in accordance with the Mongolian Company Law. In general, companies may either take the form of limited liability companies (LLC) or joint stock companies only.[22] Therefore, private funds have no choice of legal entity form other than LLC.

The highest governing body of a private fund is a meeting of the investors or members holding unit rights. Private funds may operate without a board of directors, but they could appoint the same if they consider it is necessary. Otherwise, an investment fund will be represented by a fund manager (investment management company) whose authority will be determined in the asset management agreement.

As a LLC, the private fund will be subject to Company Law requirements. However, fund laws created a separate legal personality for the fund SPV. As such, some of the conditions and requirements for the fund SPV contradicts the certain requirements under the Company law. From a legal perspective, such contradictions may not be a big issue, because of the general principle of conflict of laws under the Civil Code. The Civil Code provides that "If the Constitution of Mongolia and/or this Civil Code conflict with other laws, the provisions, which shall prevail, will be those that regulate the issue in greater detail, or in the absence of such shall be those of the law that went into effect most recently."[23] Therefore, the fund law requirements must be prevailing and any

[18] "carry hurdle" refers to the rules that the fund manager must provide a preset return to fund investors before obtaining any carried interest (performance fee).
[19] "carried timing" refers to the rules that govern timing of carried interest distributions.
[20] *Supra* note 7, Art. 38.8.
[21] *Supra* note 3, Art. 7.
[22] Company Law, Art. 3.4, State Gazette, 2011, No. 42.
[23] Civil Code, Art. 3.3, State Gazette, 2002, No. 7.

company law related issues, which are not regulated under the fund law, then would be subject to the Company Law.

However, from a practical perspective, such contradictions might trigger certain misunderstandings and disputes among stakeholders. For example, the Investment Fund Law clearly sets out that "an investment fund shall be independent from its investing entities" and "an investment company shall not be subject to parent-subsidiary related liabilities as stated in the Company Law".[24] However, because of lack of knowledge and unpopularity of private fund businesses, and untested newly approved fund laws, it is highly likely that Mongolian investors and/or relevant authorities, such as tax, registration, anti-competition, first instance courts, etc., might apply commonly accepted Company Law requirements against the funds' separate legal personality for the next few years. These misunderstandings and disputes could be finally settled correctly in the courts, but these incidents trigger additional burdens, expenses and even reputational risks.

2.5 **Exits and Liquidation**

In many countries, including the US, UK, India, Germany, Australia, Ireland, etc., the commonly used exit strategies are: (i) secondary sales, (ii) trade sales, (iii) IPOs, (iv) refinancing; and (v) restructuring/insolvency.[25] Most of these options are also available in Mongolia with certain conditions and prior agreements. However, issuance of derivatives derived from the fund's interest is prohibited.[26]

The law authorizes the fund manager and investors to contractually agree on exit procedures and that must be reflected on the fund's internal asset management regulation[27] and charter of the fund.[28] Therefore, the fund's bylaws could state secondary sales and/or trade sales as the authorized exit procedures. However, there are other obstacles that need to be considered. For example, the buyer must be a "professional investor" (please see more details in the section 3.1 of this paper).

In addition, it is not clear whether such transfer of fund interest (unit) must be reflected in the fund's state registry. As a general requirement, ownership of shares in a Mongolian LLC is evidenced by and has become effective only upon registration with LERO.[29] The private funds, as special purpose LLCs, is also subject to such a requirement of registration with LERO. Further, any modification to the shareholding structure, charter or the shareholders of a company must be registered with the LERO within 3 days of such modification.[30] Therefore, a transfer of shares is largely regulated by practice, particularly by rules imposed by LERO. LERO requires many documents including a share sale/transfer agreement, an amended charter, and relevant corporate

[24] *Supra* note 3, Art. 7.2.
[25] *See* Private Equity: Jurisdictional comparisons (Charles Martin et al. eds., 2d ed. 2014).
[26] *Supra* note 3, Art. 23.4.
[27] *Id*. Art. 25.2.
[28] Regulation on Establishing Private Investment Funds and Registering the Founding Documents (approved by the Financial Regulatory Commission Resolution No 254, Jun. 25, 2014) Art. 4.1.3.
[29] Legal Entity Registration Office (LERO) is state authority responsible for registration of legal entities in Mongolia. *See* General Law on State Registration, State Gazette, 2009, No. 26. *See also infra* note 30.
[30] Law on Registration of Legal Entities, Art. 11.3 and 11.1.8, State Gazette, 2015, No. 8.

resolutions for reflecting such a change of share transaction. However, it is not clear whether any changes to the fund's investors, would be subject to these modification related-requirements. It appears that legislation is currently silent in this regard. Therefore, it is most likely that any changes to a private fund's investors would be subject to such registration as well. It should be strongly recommended to decrease such hectic procedures by adopting separate regulations for private fund-related modifications.

Private funds may be liquidated by a resolution of the members' meeting or on a court order. Specifically, an investment fund may be liquidated (i) upon the expiry of its term; (ii) dissolution by a resolution of the members' meeting on a voluntary basis or on the occurrence of certain events; (iv) upon the entry into force of a court decision for the involuntary liquidation of an investment fund following the occurrence of an emergency event;[31] (v) insolvency; and (vi) such other circumstances as maybe provided by law. The fund legislation provides detailed regulations on the liquidation procedure and ranking of claims. Investors are entitled to receive the residual assets on a pro rata basis following the satisfaction of prior relevant claims.

The liquidation process (excluding the time required for compiling and preparing the application documents) can generally be completed within three to four months. However, in practice, occasional administrative backlogs at the relevant authorities may slow the process down to six months or more.

2.6 **Asset Management Agreement**

As a general requirement, a fund manager cannot manage the fund's assets without concluding an asset management agreement with the fund.[32] An asset management agreement is one of the key requirements to setting up a private investment fund and the draft agreement must be included in the preliminary registration application to the FRC. Such draft must be the final draft ready to be executed between the parties.[33] The agreement shall have the same term with the fund's term.

It appears that the policy makers imposed various requirements on the asset management agreement in order to protect the investors. This was mainly achieved by providing mandatory provisions to be included in this agreement. The FRC regulation provides a list of 14 items[34] as a minimum mandatory provision. These mandatory provisions are standard and there are no onerous or unusual terms in this regard.

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[31] Emergency event refers to any of the following events: (i) where insolvency proceedings have been brought in relation to an investment fund, investment management company or custodian; (ii) where circumstances have arisen which may lead to the liquidation of an investment fund; and/or (iii) where a competent authority has decided to reorganise an investment fund based on statutory grounds. *supra* note 3, Art. 34.1.

[32] Regulation on Licensing and Operations of Investment Fund Management Activities (approved by the Financial Regulatory Commission Resolution No 8, Jan. 15, 2014), Art. 6.2.

[33] *Supra* note 28, Art. 2.6.6 and 2.7.

[34] These include: (i) type and form of services provided; (ii) assets and securities; (iii) rights and obligations; (iv) investors' meeting; (v)redemption/withdrawal rights; (vi) investment amount and instruments; (vii) management fee, bonus and related information; (viii) asset management and custody; (ix) information to be provided to investors; (x) details of fund manager; (xi) termination of agreement; (xii)force majeure events; (xiii)governing law and dispute settlement; and (xiv) provisions other than those prohibited by the laws. *supra* note 32, Art. 6.5.

Further, the law requires that the fund manager has to introduce investors about the general legal framework in relation to asset management services before entering into the agreement. The fund managers are also obliged to notify the FRC of any amendments made to the asset management agreement within 3 working days after such amendment. More importantly, it is prohibited from contractually carving-out or decreasing the level of statutory obligations of fund managers.[35] It is also prohibited to include any provisions which would exempt the fund managers from liabilities caused by their breach of the same agreement.[36]

Except certain standard requirements and procedure-related burdens, both investors and fund managers have the broad flexibility to include any mutually-agreed terms on the asset management agreement. Mongolian law is based on an overarching principle reminiscent of the English law constitutional principle that "everything which is not prohibited is allowed". This is codified in the Civil Code: "Participants to civil legal relationship may, at their own will, exercise any rights and duties that are not prohibited or directly stated in the law".[37]

More importantly, as interested by many foreign entities, it is possible to specify a governing law other than the law of Mongolia. The general statutory rule is that the parties to a contract are free to designate the law of the state governing their rights and obligations, the content of their contract, the fulfilment of their obligations, the termination or revocation of their contract, and the implementation of their duties or the failure thereof ,[38] unless otherwise expressly required by law. No law requires the asset management agreement to be governed by Mongolian law.

In addition, except for certain exceptions,[39] the parties have the right to choose arbitration as a dispute settlement method and the courts do not have the authority to intervene in a matter which the parties have agreed to resolve through arbitration. Mongolia is a party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention)[40] and therefore, it is possible to enforce foreign arbitral awards in Mongolia.

2.7 **Tax**

The tax system should be probably one of the most attractive factors doing private investment fund business in Mongolia, except for a few issues of uncertainty. Such issues of uncertainty will be elaborated after the introduction of the main tax benefits.

First, in order to support the new legal reform on investment fund business, Mongolian policy makers introduced a tax incentive by making an amendment to the Corporate Income Tax Law to exempt the income of investment funds from Mongolian

[35] *Supra* note 28, Art. 5.3.
[36] *Id*. Art. 5.4.
[37] *Supra* note 23, Art. 13.2.
[38] *Id.* Art. 549.1.
[39] Certain aspects affecting the relationship between the parties must be governed by Mongolian law, including but not limited to limitation periods, immovable property pledge agreements, ownership rights in several circumstances, form of a contract in relation to real estate located in Mongolia, and so forth. *See* Law on Immovable Property Pledges, State Gazette, 2009, No. 28. *See also supra* note 23.
[40] *Contracting States of the New York Arbitration Convention on the Recognition and Enforcement of Foreign Arbitral Awards,* The New York Arbitration Convention, http://www.newyorkconvention.org/countries.

corporate income tax.[41] As such, Mongolia-incorporated private funds would be exempt from corporate income tax. "Otherwise, the tax treatment of private funds will be as same as that of other corporate entities in Mongolia. For example, in the absence of specific regulations, it appears that dividends and profits to be distributed by investment funds to their corporate investors would be taxed in accordance with the general framework within the Corporate Income Tax Law or the Personal Income Tax Law, if profits are distributed to individual investors".[42]

Second, Mongolian corporate income tax and withholding tax rates are relatively lower than average compared to other jurisdictions.[43] But Individual income tax is currently 10%[44] for most incomes,[45] including dividend income from private funds. The government has recently approved a progressive tax system to get higher taxes from individuals with higher income, but the proposed maximum tax rate would be 25%.[46] The corporate income tax rate is 10%, if a corporate entity's annual taxable income is under MNT 3,000,000,000.[47] Any income which exceeds this threshold will be subject to a 25% income tax.[48]

Withholding tax for income obtained or originating from Mongolia is 20%, except otherwise agreed in the double tax treaties.[49] For example, a withholding tax in relation to dividends can be reduced up to 5-10% under the Double Tax Treaty between Singapore and Mongolia.[50] Mongolia signed double tax treaties with 29 countries, including Singapore, Netherlands, Canada, Korea etc., but terminated 4 of them (Luxembourg, Egypt, Kuwait and United Arab Emirates).[51]

Notwithstanding the above mentioned benefits of tax exemption and average tax rates, there are few issues of uncertainty. For example, it is not exactly clear what tax rate would be applicable for investors' income from the sale of their unit rights of the private equity funds. Generally, any income from the sale of company shares are subject to 10%. However, from a technical perspective, although the private equity funds have the form of a special type of LLC, the term of "unit rights" make it more confusing for taxing purpose in the case of sale of such unit rights. This is because any income from "sale of rights" will be subject to a 30% tax rate.[52] Income from the "sale of rights" is defined as

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[41] Law on Income Taxes of Business Entities, Art. 18.1.11, State Gazette, 2006, No. 38.
[42] *An Overview of the Law of Mongolia on Investment Funds,* Hogan Lovells LLP, http://www.hoganlovells.com/files/Uploads/Documents/An_Overview_of_the_Law_of_Mongolian_on_Investment_Funds.pdf (last visited Jan. 15 2017).
[43] "The worldwide average corporate income tax rate, across 188 countries and tax jurisdictions, is 22.5 percent. After weighting by each jurisdiction's GDP, the average rate is 29.5 percent". *see Corporate Income Tax Rates Around the World 2016*, the Tax Foundation, https://taxfoundation.org/corporate-income-tax-rates-around-world-2016/.
[44] Law on Individual Income Taxes, Art. 23.1, State Gazette, 2006, No. 38.
[45] Tax is 2% for income from sale of real estates, 5% for income from new design, product, organizing cultural or sport activities, prizes from similar activities etc., and 40% for income from lottery etc., *see supra* note 41 and note 44.

[47] As of March 2017, MNT 3 Billion would be equal to approximately USD 1.25 Million.
[48] *Supra* note 41, Art. 17.1.
[49] *Id*. Art. 17.2.9.
[50] Double Tax Treaty, Mongolia-Singapore, Art.10, Oct. 10 2002, https://www.iras.gov.sg/IRASHome/uploadedFiles/IRASHome/Quick_Links/singapore_mongolia_dta.pdf.
[51] *Double Taxation Agreement*, General Taxation Authority of Mongolia, http://en.mta.mn/c/view/12118.
[52] *Supra* note 41, Art. 17.2.7.

"any income from a legitimate transfer (with consideration) of rights for certain activities issued by the competent authority, or rights to possess or use of assets".[53] Therefore, it could be arguable that the sale of units of the private equity funds shall be considered as a sale of rights, because such "units" are indeed "rights" for the purpose of definition under tax law. It is also strongly arguable from the other side that "units" are "shares", not rights, as private funds are companies. These provisions have not tested yet at Mongolian courts and it could create disputes among investors and tax authorities. Therefore, in order to prevent from such disputes, it is recommendable that the tax authority issues certain guidelines or methodology. The tax authority has such authority to issue certain methodologies or rules in order to implement the tax laws.[54] To summarize, "sale of units" shall be treated similarly to the sale of shares and therefore subject to a 10% tax rate.

2.8 Licensing requirement and exemption of private equity funds

Mongolian laws require business entities to obtain a special license in order to engage in certain business activities. The Licensing Law contains a relatively comprehensive list of business activities that require special licenses.[55] In general, "securities market related business activities" are licensed activities.[56] These activities are considered as the regulated activities and the Securities Market Law sets out a broad list of activities as the regulated activities.[57] "Investment fund activity"[58](mutual funds only) and "investment fund management"[59] are both included in this list and therefore considered as licensed activities.

However, the activity of "private investment fund" is not considered as regulated activity,[60] and therefore it is exempted from licensing requirements. This is because the general principle, under the Licensing Law, is that business activities other than those requiring a special license may be freely conducted in accordance with the relevant laws, standards and regulations upon registration with the relevant registration authorities.[61] This principle is reminiscent of the common law constitutional principle that "everything which is not prohibited is allowed".

2.9 Fund Manager[62]

Unlike "private funds", activities of "fund management" is a licensed activity. Only Mongolian-incorporated legal entities can obtain a license. This means that foreign managers are generally not eligible to obtain such licenses, and must establish a legal entity in Mongolia for that purpose. The license will be issued by the FRC in accordance with Investment Fund Law and detailed procedures stated under the FRC's Regulation on Licensing and Operations of Investment Fund Management Activities. The key

[53] *Id.* Art. 8.2.
[54] General Taxation Law, Art. 28.1.2, State Gazette, 2008, No. 22.
[55] Law on Licensed Business Activities, Art. 15 and 16, State Gazette, 2001, No. 6.
[56] *Id.* Art. 15.3.5.
[57] *Supra* note 7, Art. 24.1.
[58] *Id.* Art. 24.1.12.
[59] *Id.* Art. 24.1.13.
[60] *Supra* note 3, Art. 5.3.
[61] *Supra* note 55, Art. 5.2.
[62] The actual legal term under Mongolian law is "investment management company". *supra* note 3, Art. 4.1.11.

requirements for the fund managers are the following[63]:

- Fund manager must be a company in accordance with the Company Law.
- Fund manager must have a board of directors with at least 3 members (majority of them must be independent).
- Fund manager must have an internal audit team with at least 3 members appointed by the board of directors.

The other requirements are more technical and somehow burdensome, but not onerous or non-standard. These requirements include a minimum capital requirement, requirements for the founders or shareholders, board members, the management team and audit team members. Most of these requirements are consistent with the sound corporate governance principles in order to protect the investors.

The fund manager is vital in the private investment fund business, because only licensed investment management companies may establish investment funds and manage their assets on the basis of asset management contracts.[64]

2.10 Fiduciary Duties and Statutory Obligations of the Fund Managers

The concept of "fiduciary duty" may have different meanings and definitions in different jurisdictions.[65] In general, it basically relates to the fiduciary's high level obligations to be loyal and avoid conflicts of interests in order to protect the principal's interest. Although it is a well-established duty for certain areas (such as general partners owing fiduciary duties to limited partners under the partnership law and corporate directors owing fiduciary duties to the company under the company law), it might not have similar legal effects in the private funds. For example, under Delaware laws, the fiduciary duties of the fund managers can be eliminated by contractual arrangements[66] and therefore the fund managers may not owe fiduciary duties to their investors. In Mongolia, the specific term or concept of "fiduciary duty" has not been developed by the courts yet. Instead, the fiduciary duties shall be regulated under, and in accordance with, the asset management agreement between the investors and the manager(s). The parties could agree to include any specific duties which would not be contradictory to the

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[63] *Supra* note 32, Art. 2.2.

[64] *Supra* note 3, Art. 14.1, 24.5 and 44.1.

[65] For example, "fiduciary duty" generally refers to duty of loyalty in Canada. *see Fiduciary Duties and Financial Advisors Frequently Asked Questions and Answers,* The Investment Funds Institute of Canada, https://www.ific.ca/wp-content/uploads/2013/08/Fiduciary-Duties-and-Financial-Advisors-Frequently-Asked-Questions-and-Answers-August-2011.pdf/1658/ . In US, "fiduciary duties" could refer to duty of loyalty, duty of care, and/or duty of good faith. *see I've Been Sued for What? Fiduciary Duty Claims Against Hedge Fund Managers and How to Avoid Them,* Hahn & Hessen LLP, https://www.hedgeco.net/whitepapers/files/Fiduciary-Duty-Claims-Against-Hedge-Fund-Managers-and-How-to-Avoid-Them-White-Paper.pdf.

[66] The fund managers can contractually eliminate their fiduciary duties except for "the implied contractual covenant of good faith and fair dealing". This fiduciary duty elimination can be agreed for both LLP or LLC forms. The Delaware Limited Partnership Act provides that "*to the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing*." Del. Code Ann. tit. 6, § 17-1101(d) (2015). The same elimination provision is authorized under the Delaware Limited Liability Companies Act. Del. Code Ann. tit. 6, § 18-1101(e) (2015).

relevant laws and legislation. As such, the concept of fiduciary duty has no different legal effects than general contractual obligations under Mongolian law.

More importantly, the Mongolian fund legislation imposes certain statutory duties on fund managers and these statutory obligations have more strength to protect the investors, rather than contractually agreeable "fiduciary duty" protections. For example, the following statutory obligations require fund managers to take certain duties in order to protect the interests of their investors:

(i) to keep the fund assets in custody of the custodian;[67] and
(ii) to provide certain information to the investors.[68]

In addition, the law prohibited the fund managers from using the fund assets repugnant with the investment policy document,[69] transferring the asset to the third party without any consideration;[70] using the asset as securities and/or guarantees,[71] etc.

2.11 **Personal Liabilities of the Fund Managers**

Under Mongolian law, it appears that the fund managers bear relatively high risks of personal liabilities. The nature of these risks are derived from the following:

First, the fund managers cannot eliminate their liabilities to pay the damages in relation to their breach of asset management agreement. Any agreements with such provisions shall be void under Mongolian law.[72]

Second, the law mandates that fund managers shall be personally liable for damages caused to the fund assets by their reckless or intentional actions.[73] There are no defined terms or court-made interpretations with respect to "reckless or intentional actions", and therefore the fund manager(s) and investors could contractually agree to what constitute such reckless or intentional actions.

Third, the fund manager's management role in the private investment fund triggers certain harsh and onerous liabilities under the Company Law. Private funds must be incorporated as a company in accordance with the Company Law and therefore any issues, which are not regulated under fund related laws, would be subject to the general requirements under the Company Law. Mongolian Company law has the concept of a "governing person", and such the "governing person" will be liable to the company for any losses caused to the company by his or her unlawful actions. The statutory "governing person" includes the board directors, an executive director, a member of the executive management team, the chief financial officer, a general accountant, the corporate secretary and the general officers.[74] The company may add additional positions

[67] Investment funds must engage with the licensed custodians for the purpose of safe-keeping their assets and records and enter into custodial agreements. *See supra* note 3.
[68] *Supra* note 3, Art. 44.8.4.
[69] *Id.* Art. 46.1.1.
[70] *Id.* Art. 46.1.3.
[71] *Id.* Art. 46.1.5.
[72] *Id.* Art. 46.8.
[73] *Id*. Art. 46.10.
[74] *Supra* note 22, Art. 84.1.

as "governing person" by providing extended list in its charter.[75] Although it is not certain, it would be highly arguable that the fund managers would be considered as the "governing person" of the funds. Because there will be no separate executive director or management team for the fund, similar to typical companies. Therefore, the fund managers bear additional risks of personal liability under the company law concept of a "governing person" for any loss caused to the private fund, its "shareholders" (investors) and creditors,[76] if the fund managers committed certain illegal activities or omissions.[77]

Finally, the Mongolian fund managers will not have any specific or well established legal doctrines or rules to defend themselves at court.[78]

These high risks of the personal liabilities of fund managers could be one of the fundamental reasons for the unattractiveness of fund management activities in Mongolia. Therefore, fund managers may need to consider other non-restricted measures to protect themselves. The professional liability insurance and indemnity or exculpation related contractual arrangements could be fair methods to negotiate with the investors.

3. CONCLUSION

Mongolia has made significant efforts to improve its legal framework for private fund activities. "The enactment of the Investment Funds Law is a positive development in increasing the liquidity of Mongolian capital markets, the funding opportunities for Mongolian companies and for providing alternative investment avenues for investors".[79]

To conclude, the Mongolian new legal framework is relatively liberal and offers various advantages and protection to private investment funds and the investors. For example, fund income will be exempted and investors' dividends and other sales-related income will be subject to relatively low rates. Default withholding tax rates are average and could be subject to further reduction.[80] The fund manager and investors could contractually agree on various internationally recognized principles, except such arrangement is exclusively prohibited by laws. Therefore, management and bonus fee arrangements, investment strategies, investment period, lock-up and/or redemption rights and various other common terms could be valid and workable. Although not tested at the courts, it also appears that the investors will have higher bargaining powers in case of

[75] *Id*. Art. 84.2.
[76] *Id*. Art. 85.2.
[77] These include: (i) uses the name of the company for personal benefit; (ii) knowingly gives false or misleading information to shareholders or creditors; (iii) does not fulfill his obligations to provide information; (iv) fails to keep company documents secure as required by law; or (v) does not produce the information specified in law to the authorized persons who have the right to receive the information, or produces it with undue delay. *supra* note 22, Art. 85.2.
[78] In some common law jurisdictions, it is possible to have certain court-made legal doctrines and rules, so the business managers might use such rules as defense methods at the court trials. For example, under the Delaware Law, although not related to the fund managers, the directors of the corporations could be protected under the doctrine of "business judgement rule", if the relevant decisions meet the certain criteria. These include: (i) not involving self-interest; (ii) act on an informed basis; (iii) act in good faith and (iv) act in honest belief that the actions are the corporation's best interest. (*Grobow v. Perot*, 539 A.2d 180 (Del. 1988)). In case of duty of loyalty related claims, the board directors can protect themselves by doctrine of "entire fairness". (*Weinberger v. UOP*, Inc., 457 A.2d 701 (Del. 1983)).
[79] *Supra* note 42.
[80] It will be subject to the availability and application of Double Tax Treatment. Please see more details in the tax section of this paper.

disputes between the fund manager and the investors due to above-mentioned "governing person" concept and statutory obligations.

In addition to these advantages under fund related legislation, the investors and/or the funds could further enjoy other tax[81] and non-tax benefits[82] in accordance with the Investment Law,[83] which is a general framework law to attract foreign and domestic direct investments.

On the contrary, its main disadvantages relate to the Mongolian general business legal framework and practices, rather than fund-related legislation. In other words, the issues of uncertainty and/or fund-law related regulations (as mentioned in this article) seem to be more technical, or minor, or preventable by various legal and others measures. However, the main legal challenge (notwithstanding other non-legal issues such as market practice, knowledge and sophistication of relevant stakeholders, availability of investment options etc.) could relate to the two fundamental legal issues with respect to the doing business in Mongolia.

The first one would be the inconsistent enforcement of Mongolian legislation. Despite the continuous effort to implement economic reforms for a free-market democracy, the legal environment for business in Mongolia remains unsophisticated. Poorly-drafted legislation creates disparities in understanding and results in patchy and inconsistent enforcement. As government officials have discretion to impose requirements that are not stipulated in the law, the actual implementation of law becomes heavily dependent upon overreaching rules of interpretation applied haphazardly through administrative practice. This encourages corruption and malpractice at the administrative level, which, in turn, has resulted in no interest of business.

The second one relates to the courts. In practice, the main court-related problems could be nationalism, ignorance of commercial principles among some judges, and a lack of binding precedent. A significant numbers of Mongolian judges were trained during the socialist era (1921-1990) and may at times struggle to apply market-oriented principles over Marxist-based jurisprudence. However, recent judicial decisions have shown a growing commercial sophistication amongst the judiciary, and the tendency is certainly towards a gradual improvement of the entire judicial system.

Thus, although the fund managers and investors will enjoy various advantages in relation to their fund businesses, they should also need to consider the above-mentioned general risks and must be careful when drafting the legal documents, choosing local counterparties, and managing their daily operations.

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[81] Investment Law, Art.11. State Gazette, 2013, No. 41.
[82] *Id*. Art. 12.
[83] Investors could enjoy tax benefits (stabilization of certain taxes, exemption of certain taxes, and preferential tax treatment) and non-tax benefits (in relation to land rights, customs clearance, foreign labor quotas, and immigration matters) by obtaining stabilization certificate or entering into the investment agreement with the Government. However, it will be subject to certain requirements (investment amount, investment sector, and investment geographical area) and benefits will vary depending on these factors as well. *See supra* note 81.

From a policy perspective, in order to develop the capital market, attract foreign direct investment and/or support investment fund businesses, Mongolia further needs to expedite its actions to cure the above mentioned two fundamental legal issues, which impact all businesses in Mongolia.