

Turkish Private Equity Investment Funds

18 April 2018



Contents

<i>I. Turkish PEIFs</i>	4
<i>II. Establishment of a PEIF</i>	7
<i>III. Management of a PEIF</i>	8
<i>IV. Terms</i>	10
<i>V. Participation Units</i>	10
<i>VI. Commitments of QIs</i>	14
<i>VII. Eligibility for the QI Status</i>	14
<i>VIII. Minimum Investment Requirement For Pension Funds</i>	14
<i>IX. Investment Restrictions</i>	14
<i>X. Dividend Distributions</i>	18
<i>XI. Protection of Fund Assets</i>	19
<i>XII. Custodian</i>	19
<i>XIII. Supervision of PEIFs</i>	19
<i>XIV. Reporting and Disclosure</i>	19
<i>XV. Termination and Liquidation</i>	20
<i>XVI. CMB Fee</i>	20
<i>XVII. Taxation of PEIFs</i>	20
<i>XVIII. Taxation of PEIF Investors</i>	22
<i>XIX. Other incentives for PEIFs investing in start-ups</i>	22

Turkish Private Equity Investment Funds in a nutshell



Umurcan Gago
Gündüz Şimşek Gago
Attorneys at Law
Partner

Turkish Private Equity Investment Funds (“PEIFs”) are lightly regulated investment vehicles formed by Portfolio Management Companies (“PMCs”) or Private Equity Portfolio Management Companies (“PEPMCs”)¹ which are also known as sponsors, principals or founders, seeking to raise capital from investors to make private equity investments in Turkish companies. Turkish PEIFs are regulated and supervised by the Capital Markets Board (“CMB”). Turkish PEIFs may have various purposes and strategies, such as: ‘venture capital’ funds that invest in early and development stage companies, ‘growth equity funds’ that invest in later-stage or pre-IPO companies, buyout funds that acquire controlling interests in companies with an eye toward later selling those companies or taking them public, ‘infrastructure funds’ that invest in infrastructure projects, PPPs, ‘distressed asset funds’ that invest in debt securities of financially distressed companies at a large discount and ‘real estate funds’ that invest in companies holding or developing real estate.

Moreover, Turkish PEIFs may be formed to invest in specific industry sectors (such as technology, energy, healthcare, trade or manufacturing). Turkish PEIFs are restricted from making any public offering, as their units can only be sold to Qualified Investors (“QIs”). QIs make a commitment to invest a set amount of capital, entrusting the founder to source, acquire, manage and divest the fund’s investments. The key economic incentives for founders of Turkish PEIFs are management fees and performance fees which are based on profits of the PEIF and are commonly known as ‘carried interest’. The key economic incentive for QIs is the opportunity to earn a high rate of return on their invested capital through access to a portfolio of investments sourced and managed by an expert investment team.

It has been legally possible to establish PEIFs in Turkey since July 2014

PEIFs have been introduced into Turkish law by the CMB Communiqué “Principles Regarding Private Equity Investment Funds” (“PEIF Communiqué”), which was published in the Official Gazette dated 2 January 2014 (No. 28870). This Communiqué aimed to provide the regulatory framework for the establishment and operation of Turkish PEIFs, the sale of Turkish PEIF Units to QIs, and related transparency and reporting requirements for Turkish PEIFs. The Communiqué became effective on 1 July 2014. Thus, from July 2014 it became legally possible to establish PEIFs in Turkey. Since then PEIFs have started to attract a diverse range of investors, especially in infrastructure, growth and venture capital type of investments.

The Communiqué provides a lightly regulated and flexible regulatory model, inspired by international market standards and customary practices for PEIFs. Some of the rules set forth by the Communiqué seem to have been inspired by the Alternative Investment Fund Managers Directive (“AIFMD”). For example, parallel to the AIFMD, the Communiqué sets out detailed custodianship, transparency and reporting requirements for sponsors and/or managers. Additionally, the Communiqué on Portfolio Management Companies², which introduced the PEPMC concept to Turkish law for the first time, was similarly derived from the AIFMD. Since then we have seen a rapidly increasing number of PEPMCs being established³.

¹ There is another type of PMCs called “Real Estate and Private Equity Portfolio Management Companies”, which are also able to establish both PEIFs and Real Estate Investment Funds.

² The CMB Communiqué Principles regarding Portfolio Management Companies and Activities of Portfolio Management Companies, published in the Official Gazette dated 2 July 2013 (No. 28965).

³ The current list of PEIFs and PEPMCs can be found at <http://spk.gov.tr/Sayfa/AltSayfa/1258> and <http://spk.gov.tr/SiteApps/Kurum/YetkiBelgeleri/pys>



I. Turkish PEIFs

Turkish PEIFs are defined as assets without any legal personality, established with a Circular⁴ (and an Investors or Fund Agreement- “IA”) and managed by PMCs or PEPMCs holding operating license issued by the CMB, for a definite period of time, for the purpose of making investments mainly in Turkish Private Equity Investments (and to a limited extent in Other Allowable Investments), on behalf of QIs on the basis of fiduciary ownership.

Under this framework, Turkish PEIFs are similar to English Law PEIFs, which are established as Limited Partnerships. A founding PMC’s or PEPMC’s role is similar to that of a General Partner (principal) and unless the management is outsourced to another PMC or PEPMC, the Founder also acts as the manager. QIs are similar to limited partners. The Circular, IA⁵ and the Issuance Certificate (“IC”)⁶ governing the partnership relationship are akin to the Limited Partnership Agreement governing the English Limited Partnership form of a PEIF (or an LLC agreement when the PEIF is formed as an LLC), and the Key Investor Information Document (“KIID”)⁷ is a marketing material similar to Private Placement Memorandums.

The key characteristic features of PEIFs⁸ can be summarized as below:

- PEIF Units can only be sold to QIs;
- PEIFs can only be established and managed by Turkish PMCs or PEPMCs which require a license issued by the CMB;
- The Founder⁹ may manage the fund, or alternatively, a third party Turkish PMC or PEPMC can be assigned as the manager;
- Unlike Private Equity Investment Companies (“PEICs”), PEIFs do not have legal personality but rather they are *asset pools* contractually created through the Circular and IA;
- PEIFs have defined terms and they are liquidated at the end of their terms;
- PEIFs cannot engage in any activity other than Private Equity Investments (investments in qualifying Turkish target companies that have potential for growth and require resources) and Other Allowed Investments;
- At least 80% of the Total Value of the PEIF should be composed of Private Equity Investments;
- Assets of PEIFs should be kept by an independent portfolio custodian;
- Assets of PEIFs must remain separate from the assets of the Founder (Principal), the Custodian, and the Portfolio Manager;
- PEIFs are regulated and supervised by the CMB;
- PEIFs are fully exempt from taxation; and
- Investors in PEIFs enjoy tax exemptions and subsidies¹⁰.

4. The Circular is an adhesion a contract by and between the founder of the PEIF, its custodian, its portfolio manager and QIs, describing general transaction terms about the custody of the fund’s assets and, the management of the fund’s portfolio pursuant to the principles of fiduciary ownership.

5. An Investment Agreement is an agreement made between the fund and QIs in respect of payment principles for capital commitments. Payment plan, measures to be taken in the event of a breach of commitments, as well as lower and upper limits of capital commitments shall be included in this agreement and such total may be requested by the founder within notice periods to be determined by the board of directors of the Founder/Manager.

6. Issuance Certificate is a form requiring CMB approval prior to issuance and which shows the characteristics of the fund and the terms of sale of the participation units.

7. The *Key Investor Information Document* is a document which summarizes the structure, investment strategy and risk concerning the PEIF. The Founder maintains the form accurately, updated promptly and consistent with the Circular and the IC. Preparation of an KIID is optional.

8. For the remainder of this document, unless the context requires otherwise, PEIFs refer to Turkish PEIFs established in Turkey in line with the CMB PEIF Communiqué.

9. The Founder represents, manages or supervises management of the PEIF in a manner that it protects rights of participation unit owners (QIs) in accordance with the provisions of the Circular and the IC. The Founder is entitled to dispose

of assets owned by the PEIF on its behalf and on account for the PEIF pursuant to the legislation and the Circular, and exercise rights arising therefrom. Using outsourced services, including portfolio management services, during the performance of fund activities, does not relieve the Founder from responsibilities.

10. Please refer to Section XVII and XVIII of this note.

Main advantages of PEIFs

Comply with international market standards

Being inspired by international market standards and customary practices, PEIFs are more likely to attract investors as they permit the separation of investment and management functions.

Offer a reliable, transparent investment platform

PEIFs offer a transparent and reliable investment platform as they are required to be independently audited and legally required to work with a custodian (as per the Communiqué on Portfolio Depositary Services).

Lightly regulated

PEIFs are not subject to restrictions of the Turkish Commercial Code. As such, investments and divestments into PEIFs is relatively flexible.

Flexible

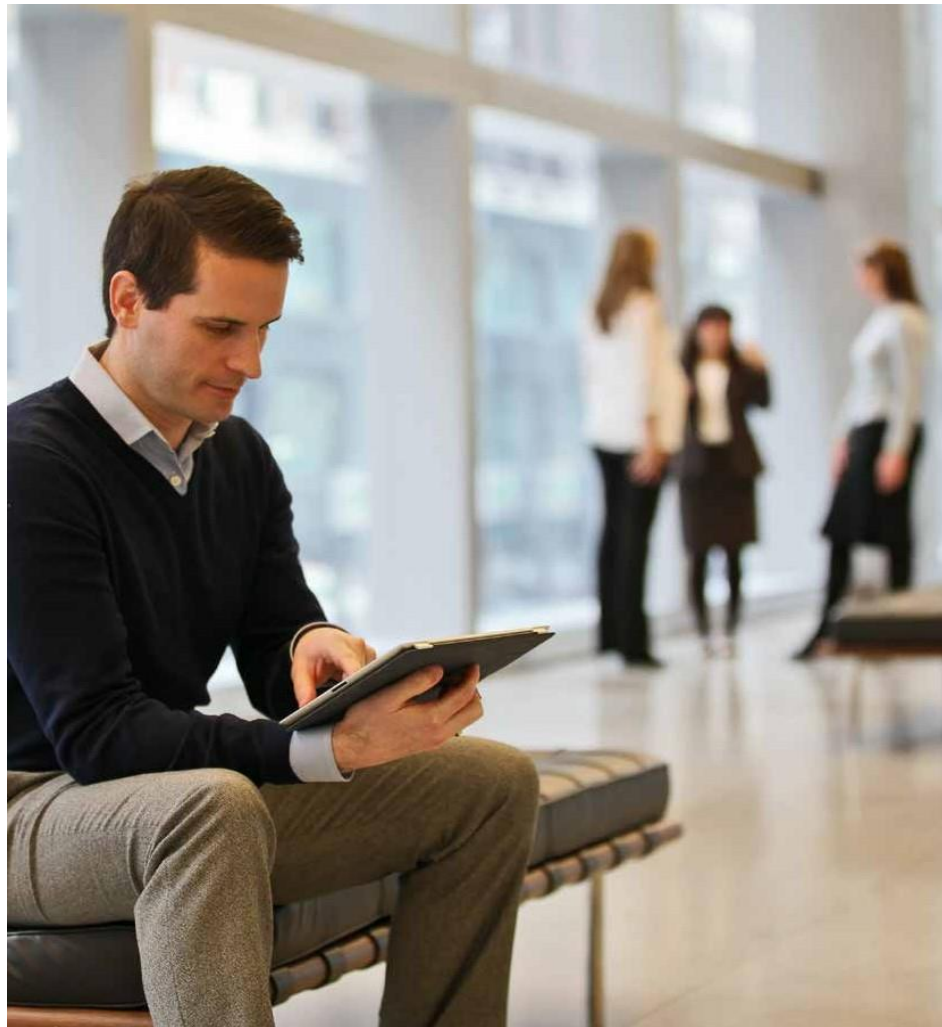
PEIFs allow additional flexibility over normal Turkish holding structure on the repatriation of funds. Further, the Founding PMC and investors have the flexibility to design the framework of the PEIF (e.g. governance, distributions etc.) without any constraints other than the Law and CMB regulations.

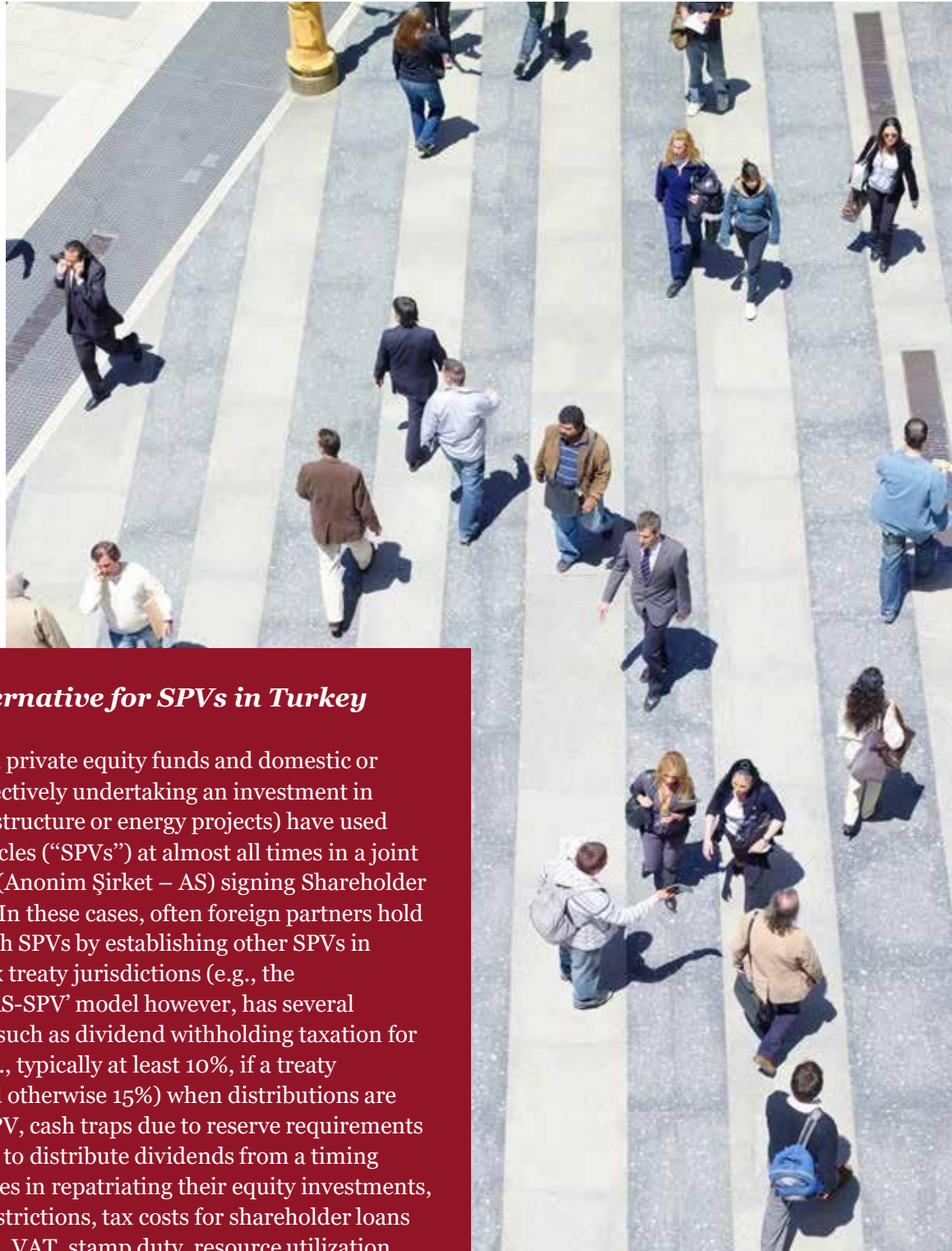
Enjoy tax advantages

The income of a Turkish PEIF is fully exempt from corporate tax in Turkey. Investors in PEIFs enjoy certain tax exemptions and tax subsidies.

White labelling in Turkey

After the introduction of PEIFs in 2014, Turkish PMCs and PEPMCs have started to offer 'white labelling solutions' to fund initiators that provide an asset management infrastructure value chain embedding governance, legal, risk management and investment capabilities as well as operational and reporting elements, whilst allowing such fund initiators to effectively focus on their core business rather than deploying these other skills in-house. We have already seen and are increasingly witnessing an upward trend of fund initiators developing an idea and undertaking fundraising and investment decisions, while PMCs and PEPMCs supply all supporting administration and infrastructure. This type of solution is also favoured by fund investors, not only because it provides a very tax-efficient investment platform in Turkey that benefits from the robust governance of a licensed fund management company guarded by a custodian bank and a regulator, but also because onboarding a professional independent manager an equal distance from all investors and the fund initiator provides an extra level of comfort for fund investors.





PEIFs as an alternative for SPVs in Turkey

Traditionally, foreign private equity funds and domestic or foreign partners collectively undertaking an investment in Turkey (e.g., in infrastructure or energy projects) have used Special Purpose Vehicles (“SPVs”) at almost all times in a joint stock company form (Anonim Şirket – AS) signing Shareholder Agreements (SHAs). In these cases, often foreign partners hold shares in such Turkish SPVs by establishing other SPVs in favourable double tax treaty jurisdictions (e.g., the Netherlands). This ‘AS-SPV’ model however, has several inherent downsides, such as dividend withholding taxation for foreign investors (e.g., typically at least 10%, if a treaty structure is used, and otherwise 15%) when distributions are made from the AS-SPV, cash traps due to reserve requirements of ASs, less flexibility to distribute dividends from a timing perspective, difficulties in repatriating their equity investments, thin capitalization restrictions, tax costs for shareholder loans (e.g., withholding tax, VAT, stamp duty, resource utilization support fund levies), potential capital gains tax leakage (effectively 5% under unique situations where a top Turkish holding company is interposed), the requirement to hold the shares of the AS for a certain period of time to avoid tax leakage on capital gains, the administrative costs of running multiple SPVs, legal risks associated with SHAs, governance issues, risks arising from the lack of an independent professional administration, to name a few. PEIFs offer solutions to almost all of these. Therefore, in the last couple of years, we have started to see the use of and a strong preference for PEIFs by foreign private equity funds and domestic or foreign partners collectively undertaking investments in Turkey.

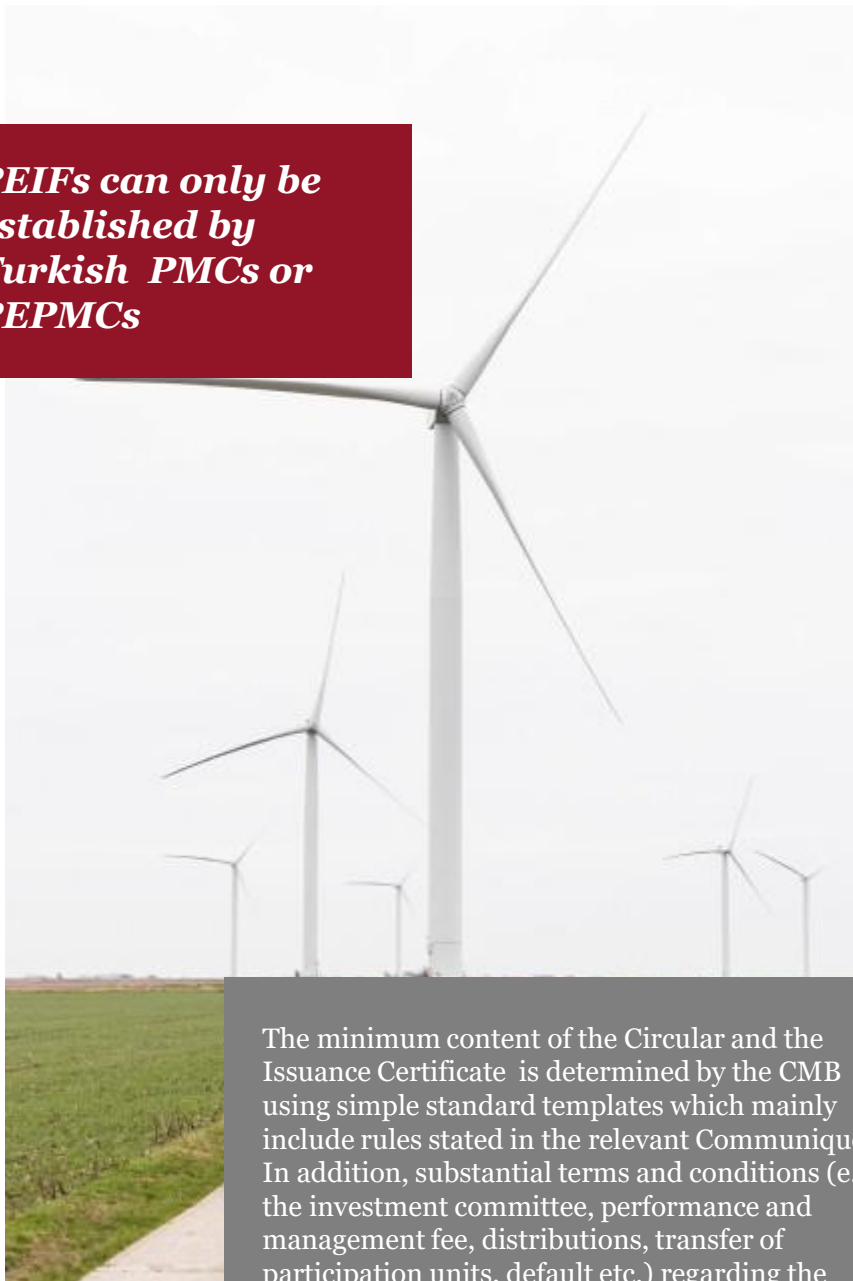
II. Establishment of a PEIF

PEIFs can only be established by Turkish PMCs or PEPMCs, which hold a license issued by the CMB.

The Founder must make an application to the CMB by submitting a draft Circular, standard form and other required documents. In order to receive permission to establish a PEIF, the Circular must be approved by the CMB and a *custodianship agreement* should be signed by the Founder and with a custodian. The CMB shall determine whether to grant permission for establishment within a period of two months following application. After receiving CMB permission, the founder must register the approved Circular with the Trade Registry Office and publish in the Trade Registry Gazette within six days.

PEIFs cannot be organized under an umbrella fund structure. There is, however, no prohibition to create a parallel PEIF or fund of funds.

PEIFs can only be established by Turkish PMCs or PEPMCs



The minimum content of the Circular and the Issuance Certificate is determined by the CMB using simple standard templates which mainly include rules stated in the relevant Communiqués. In addition, substantial terms and conditions (e.g., the investment committee, performance and management fee, distributions, transfer of participation units, default etc.) regarding the operations of the PEIFs are included in the IA signed among Investors, the PMC and the Fund.

- Sale to QIs only
- Established and managed by Turkish PMCs or PEPMCs licensed by the CMB
- No legal personality
- Exclusively invest in Private Equity Investments (qualifying Turkish target companies that have potential for growth and require resources) and Other Allowable Investments
- Fund assets are maintained by an independent custodian
- Fully exempt from taxation
- Investors enjoy several tax advantages

III. Management of a PEIF

PEIFs are managed either by the Founder or other PMCs or PEPMCs pursuant to a signed *portfolio management contract*.

Management Role

Management can be performed by several PMCs and/or PEPMCs. The manager(s) should manage assets of the PEIF for the benefit of and in line with the interests of the QIs, the rules set forth in the CMB Communiqué on Portfolio Management, and the principles set forth in the Capital Markets Law, the Communiqué, the Circular the IC and the IA.

Management Fee and Expenses

The manager(s) can charge management fees to the PEIF, capped at the amount (rate) determined in the IC. There is no regulatory cap. Management fees may be charged to the PEIF at periods determined in the Circular, the IC and the IA (e.g., on a quarterly or semi-annual basis). Amounts contributed towards management fees may or may not reduce an investor's unfunded commitment, depending on the methodology determined in the Circular, the IC and the IA. It is also possible to arrange the management fee amount in such a manner that after the end of the Investment Period the management fee is reduced, e.g., to a percentage of actual invested capital, calculated at the beginning of each fee period, or a reduced percentage of overall original committed capital. In addition, there is no regulatory prohibition against the Circular and the IC containing an offset mechanism (a *management fee offset*) requiring an adjustment to the fund management fee against a percentage of management services, transaction and other fees received by the sponsor and its affiliates from the PEIF's Private Equity Investments.

Moreover, if the Circular, the IC and the IA provides so, a Performance Fee (carried interest, or carry) may be charged at the end of each end of accounting period or on redemption dates, but exclusively on (i) dividend and/or interest receipts from Private Equity Investments, or (ii) capital gains upon exit from Private Equity Investments.

The manager is expected to bear the cost of its own ordinary administrative and overhead expenses incurred in managing the fund. These costs typically include the costs and expenses associated with running the business of the manager, as opposed to specific expenses directly related to the operation of the fund and its investments, such as employee compensation and benefits, rent and general overhead.

There is no prohibition on the Founder and/ or the manager charging the PEIFs, and therefore its investors, for organizational expenses for the costs of establishing the PEIF (e.g., out-of-pocket expenses incurred by the Founder in forming the PEIF fund, such as legal, accounting, filing and other organizational expenses). Organizational expenses are borne by the PEIF's investors out of their capital commitments, and it is possible to cap such expenses in the IC.

In addition to organizational expenses, the PEIF may bear all other costs and expenses relating to its operations, such as fees, costs and expenses relating to purchasing, holding and disposing of the fund's investments, third-party service providers to the fund (such as the expenses of the custodian, lawyers, accountants and auditors), reports to investors, insurance, indemnity and litigation expenses, taxes and any other governmental fees or charges levied against the PEIF. As with the fund's organizational expenses, the operating expenses of the fund are borne by the fund's investors out of their capital commitments.

Representation of PEIF

PEIFs are represented by the Board of Directors of their Founder, in the execution of all activities, including all contracts, participation in the management of qualifying targets and exercising voting rights in the general assembly meetings of such targets. This authority can be delegated to one or several of the board members. Certain specialized and relatively important duties and matters, however, may not be delegated, such as fund establishment, issuance of Units, liquidation, increasing portfolio management fees and other transactions which may potentially impact on investment decisions of the QIs.

Required Qualifications

Where the Founder is a PMC (but not a PEPMC), at least one of the board members of the Founder (inter alia, the PMC Board of Directors) should have five years of experience in private equity investments. An *Investment Committee* comprising at least three persons, one being such qualified Board member of the Founder, one being the general manager of the Founder and one being a University graduate on the staff with at least five years of experience in private equity investments, should be created. If the manager is not the Founder itself, such organization should be created at the level of the managing PMC and/or PEPMC.

In addition to the minimum member requirement for Investment Committees, Investors can also nominate members for the Investment Committee. There is no limitation on the number of members and no qualification criteria is determined in the regulation for the members nominated by the Investors. Furthermore, the quorum for the meeting and resolutions as well as decisions to be made (for example, decisions on investments, distributions, liquidation of the fund, borrowings, issuance of new participation units) can be determined flexibly by the investors and PMCs in the IA. Thus, privileges in relation to certain decisions can be granted to either party (i.e., investors or the PMC) by regulating the relevant terms in the IA.

In this respect, the flexibility in the governance of Investment Committees provides both investors and the managing PMCs with various alternatives for the governance structures of PEIFs.

IV. Terms

The terms of the PEIF should be determined in the IC. There are no regulatory restrictions regarding the term of a PEIF, distribution waterfall, Final Closing date, Investment Period, Divestment Period, Follow-on Investments, Early Termination Events, exclusivity terms (preventing the sponsor from forming competing PEIFs with the same investment objective as the PEIF until the end of the PEIF's investment period, or until such time as all or substantially all of the PEIF's commitments have been deployed or reserved for deployment), and provisions governing affiliated transactions between the Founder and/or the manager or their affiliates, and the PEIF or its portfolio investments, and the Investment Committee.

V. Participation Units

a. Participation Units

Participation Units (or Units) are dematerialized capital market instruments, held by the QIs representing their ownership in PEIFs. In this context, PEIFs are asset pools created with the cash (or shares of Private Equity (target) companies) collected from QIs in exchange for Units. Units do not have nominal values. The value of a Unit is determined by dividing the net asset value of the PEIF by the total number of Units. The value of Units must be calculated, in principle, at least once a year and QIs must be notified accordingly.



b. Privileged Participation Units

As long as it is explicitly permitted in the Circular, IC and IA, PEIFs may also issue privileged units, which vest rights in respect of (a) fund management and (b) distribution of dividends. Thus, a Performance Fee (based on (i) dividend and/or interest receipts from Private Equity Investments or (ii) capital gains upon exit from Private Equity Investments) can be paid by the PEIF as dividends to the privileged unit-holding Founder and/or the manager. Privileged unit-holders may form part of the manager's investment committee. Additionally, it is possible to require the consent of privileged unit-holders for the selection of Private Equity Investments in which the PEIF shall invest, the selection of managers and the determination of the exit strategy.

c. Issuance of Participation Units

In order to raise funding from QIs, the IC must be approved by the CMB. Fundraising in the absence of an approved IC would cause legal liability.

In order to initiate the issuance process, the Founder needs to make an application to the CMB by submitting the IC, a standard form and other required documents.

The IC application to the CMB should be made within 6 months from the registration of the Circular. Thus, within this 6-month period, technical infrastructure, accounting and reporting systems should be prepared by the Founder. This 6-month period may be extended by the CMB in circumstances where reasonable grounds are satisfied.

Normally we expect this to take less time, as the Founder should have such infrastructure setup already completed. Moreover, for subsequent Funds of particular Founder even less time should be required.

The CMB reviews the application and approves the IC within 20 business days. The CMB may require additional documents during the assessment period.

Where the information and documents provided to the CMB are considered incomplete or additional information and documents are required by the CMB, the Founder is notified within 10 days from the date of application. Requested information and documents must be submitted within the time period deemed appropriate by the CMB. Where the IC is not approved as a result of the review, the applicant is notified of the reasons for disapproval are notified to the applicant.

Unless it is the first PEIF of a Founder, PEIF establishment and IC approval applications are submitted together and the CMB reviews such applications at once. Where a Founder is a first-time applicant, however, applications for PEIF establishment and IC approval must be submitted separately.

IC must be approved by the CMB

d. Marketing and Sale of Participation Units

Upon CMB approval of the IC, Units can be sold to QIs through the distribution channels during the sale period announced in the IC, pursuant to principles therein as well as the Circular and the KIID (if any). QIs typically like to see that the Founder has “skin in the game” and is making its own commitment to the fund. A Founder can invest up to 20% of the Units (including privileged units) for its own portfolio. A substantial commitment by a sponsor (and preferably its key executives that meet the QI eligibility criteria) is an attractive marketing element because QIs believe it better aligns the interests of the Founder with those of the QIs, since Founders which make significant commitments share in losses as well as profits. Investors believe this mitigates the incentives for Founders, which receive a disproportionate share of profits, to take excessive risks.

Units may be sold to QIs either in exchange for cash, or in exchange for shares of a qualifying Turkish target companies provided that this is explicitly permitted in the Circular. A valuation of those shares in qualifying Turkish target companies shall be made by Valuation Companies approved by the CMB.

Marketing and distribution of Units of PEIFs can be done either by the Founder or authorized PMCs contracted by the Founder. The Founder and/or the PMCs contracted by the Founder, must seek the appropriate documentation verifying the eligibility of the investors for QI status and must maintain such documentation for at least five years. Mutual liability will be shared by the parties in the event of a breach.

Public marketing of the Units is prohibited, including the general solicitation of investors or general advertising of the PEIF (i.e., advertisements, articles, notices or other communication published in any newspaper, magazine or similar media or broadcast over television or radio). Marketing should be targeted towards potential QIs. However meetings made before the establishment of a PEIF for the purpose of identifying potential QIs are not considered public marketing.

e. Redemption of Participation Units

QIs exit from the PEIF by means of returning the Units to the Founder (redemption), pursuant to the principles established in the IC. In the event of redemption, redeeming QIs should be paid in cash. The Founder may defer redemption for up to a year and limit it to the extent the Circular grants the Founder such a right, on the grounds of lack of liquidity and/or if divestment of the Private Equity Investments can be documented to be economically unfeasible for the QIs. Moreover, as long as it is explicitly provided for within the IC and the Circular, it is possible to restrict the redemption at the termination of the PEIF.

Under the terms specified in the IC, Circular and IA, commission may be charged both on the sale of Units to QIs and the redemption of Units by QIs. Such a commission charge (if any) would be treated as income to the PEIF. However, no commission charge is allowed for the entrance to or exit from other PEIFs in cases where such other PEIFs are managed or established by the Founder, manager or other persons who are related to same.

f. Transfer of Participation Units among QIs

Units may only be transferred among persons who meet QI criteria, and which are subject to the approval of the Founder. Appropriate documentation to support such qualification criteria should be presented to the Founder.

VI. Commitments of QIs

Turkish PEIFs are structured – in principle – as closed-end investment vehicles. Turkish PEIFs are permitted to raise capital commitments during the Fund Raising Period which must be determined in the IC. After the Initial Closing, the PEIF may accept additional commitments by amending its IC to increase the total commitment amount stated in the IC.

During the Fund Raising Period, the Founder seeks QIs to make capital commitments to the PEIF. The commitments are not required to be paid all at once, but can be paid in separate capital contributions which the Founder designates by making “capital calls” on an as-needed basis during the Investment Period as determined in the IC.

There is, however, a minimum limit on capital commitments for the Initial Closing. Accordingly, capital commitments should total at least TRY five million.

The capital call should be made by the Board of the Founder and commitments should be paid by the QIs to the PEIF at the periods determined in the IA¹¹. However, the minimum capital commitment of TRY five million should be paid within one year following the date of the commencement of the sale of Units to QIs. The capital totaling TRY five million paid by the QIs should be invested in Private Equity Investments and Other Allowed Investments within the period specified in the IC, and in any case, no later than within one year.

Capital must be invested during the Investment Period to pay fees and expenses over the life of the fund. QIs commit to invest an agreed amount in the fund (the QI’s capital commitment). The Founder’s ability to call for capital contributions from QIs is limited at any time to the extent of each QI’s unfunded commitments (the QI’s total commitment minus contributions already made).

The number of Units to be transferred to the accounts of QIs according to each of their capital payments is calculated by dividing the Total Fund Value (as determined on the last valuation date) by the number of all Units. If so required in the IC or IA, a special valuation report may be prepared in respect of a Private Equity Investment portfolio, prior to the capital commitment payments.

VII. Eligibility for QI Status

Units can only be sold to QIs. Any person who satisfies the “angel investor¹²” criteria or who owns at least TRY 1,000,000 worth of financial assets, including bank reserves and/or capital market instruments shall be regarded as a QI.

The Central Registration Agency systems identify QIs and acknowledge that QIs are deemed to have accepted a lower level of protection as a result of their status, experience or special acknowledgement of the risks that they incur by investing in a lightly regulated fund vehicle by way of a declaration to be submitted to an intermediary institution.

VIII. Minimum Investment Requirement for Pension Funds

The Turkish private pension fund industry, which lags behind that of other OECD-member countries in terms of the ‘pension fund to GDP ratio’, is severely criticized on the grounds that the returns of pension funds do not meet the expected yields compared to alternative saving/investment vehicles. This is mainly because pension funds invest their portfolios in liquid and fixed income assets (e.g., government bonds, bank deposits), and their investments in listed equities is extremely limited. To encourage pension funds to make higher yield investments, albeit in less liquid assets, on 15 December 2016 and 20 June 2017 the Undersecretariat of the Treasury regulated that by 2019:

- a minimum of 10% of the assets of standard pension funds must be invested in shares of PEIFs, real estate investment funds, capital market instruments related with infrastructure projects, and Turkish Sovereign Wealth Funds; and
- 1% of a pension fund portfolio must be invested in PEIFs.

However, despite such ‘encouragement’ and the fact that there is no legal barrier hindering private pension funds from investing in PEIFs, so far private pension companies have not sufficiently grasped the opportunity, probably mainly because this requires a change of mindset regarding investing in less liquid assets and they need some time to digest the rules of the new playground.

11. With respect to payment principles of capital commitments an IA must be made among the PEIF and QIs. The payment plan, measures to be taken in the event of breach of commitments as well as lower and upper limits of capital commitments should be included in the IA.

12. Under Article 5 of the Regulation on Regarding Individual Participation Investments published in the Official Gazette dated 15 February 2014 (no. 28560), an “Angel Investor (Individual Participation Investor)” is a person who holds an Individual Participation Investor (IPI) License issued by the Turkish Treasury. An IPI License may be issued to;

- 1- Investors who have high income or wealth;
- Investors whose annual income is at least TRY 200,000 within the last two fiscal years before obtaining the license or;
- Investors, whose total amount of personal wealth including every type of movable and immovable assets is at least TRY 1.000.000.

However, the following assets are excluded from the calculation of the value of personal wealth;

- A Person’s residence or house which habitually resided in or acquired with a mortgage;
 - Rights arising out of insurance contracts, and;
 - Pension rights and life insurance payments.
- 2- Investors who have experience are defined as follows;
- An investors who has at least two years experience as a fund manager in a financial institution, as a manager and/or similar in the SME finance department of a financial institution or private venture company;

- Investors who work as at least a deputy general manager the equivalent or in a higher position in a company with an annual turnover of at least TRY 50,000,000 within the five years prior to obtaining the license; and
- Investors who have been members of a business angels authorized network for two years prior to obtaining a license and who have been shareholders in non-public companies as angel investors for three years.



In PwC's 2017 report "Transformation of the Asset Management Industry in Turkey" which is based on a survey and interviews with representatives from the asset management industry, PEIFs are cited as one of the few products with the biggest opportunities for growth in Turkey.¹³

13. <https://www.pwc.com.tr/tr/sectorler/yatirim-yonetimi/turkiyede-varlik-yonetim-sektorunun-donusumu-v2.pdf>

IX. Investment Restrictions

PEIFs cannot engage in any activity other than Private Equity Investments and Other Allowable Investments.

Moreover, at least 80% of the Total Fund Value (Private Equity Investments + Other Allowed Investments + Receivables – liabilities) of a PEIF (based on the Total Value Table as of the end of the accounting period) should consist of Private Equity Investments. This ratio is reduced to 51%, where, during an accounting period, direct investments in qualifying target companies which fall under the definition of SMEs, exceed 10% of the Total Fund Value of a PEIF.

a. Private Equity Investments

Private Equity Investments (qualifying targets) are broadly defined as investments (equity or debt) in Turkish companies that have the potential for growth and require (financial, technical or management) resources¹⁴. There is no limitation or restriction in terms of the scope of the business activity of target companies that qualify as Private Equity Investments.

The core business of the target companies may be trade, manufacture, agriculture activities or services. Target companies need not necessarily be start-up companies or small-medium size companies (SMEs). They can operate in any kind of industry (telecommunication, energy, utilities and mining, finance, retail, healthcare and pharmaceuticals, entertainment, food and beverage, etc.). Target companies may be incorporated in any form, joint stock companies or limited companies. However, limited companies must convert to joint stock form within a year following PEIF investment. Investments in foreign companies do not qualify as Private Equity Investments.

Equity investments can be made either in the capacity of a founder or through the acquisition of shares of an existing qualifying target company.

Equity investments can be made directly or indirectly through Turkish SPVs (special purpose companies established in Turkey in the form of joint stock companies whose fields of activity, as determined in their articles of association, are exclusively limited to investing in qualifying target companies), Turkish PEICs, other Turkish PEIFs or subject to certain conditions (e.g., the risk is limited to the capital investment therein) through foreign collective investment schemes (e.g., funds, trusts). However, although permissible, equity investments in publicly traded shares of qualifying target companies are not considered Private Equity Investments, rather they are classified as Other Allowable Investments. However, equity investments in private (non-trading) shares of qualifying public target companies are considered Private Equity Investments.

PEIFs can also provide debt financing to qualifying target companies, by investing in their bonds or they can provide mezzanine financing (bridge financing structured as a mix of debt and capital) to qualifying target companies.

b. Other Allowed Investments

Apart from Private Equity Investments, PEIFs are permitted to invest only in the below (Other Allowable Investments):

- Shares of Joint Stock Companies registered in Turkey,
- Public and/or private debt instruments,
- Foreign public and/or private debt instruments and shares of foreign companies as long as the requirements of the foreign exchange law are met,
- Bank deposits with terms and participation bank account deposits,
- Investment Funds,
- Repo and reverse repo transactions,
- Warranties and certificates,
- Lease certificates and real estate certificates,
- Settlement and Custody Bank money market transactions,
- Cash collaterals for derivative market instruments and premiums,
- Foreign special purpose investment instruments to be approved by the CMB, and
- Other investment instruments to be approved by the CMB.

¹⁴ Private Equity Investments should be made based on shareholders agreements (SHA) to be signed by the PEIF and the main shareholders of the target companies. The SHA should regulate the rights, duties and obligations of the PEIF and main shareholders, exit strategies, pre-emption right, collaborative liquidation, participation in liquidation, and dividend distribution policies.

c. Breach of the 80% rule and its rehabilitation

If at the end of an accounting period, incidentally (e.g., due to redemption of the fund Units, dividend receipts from qualifying target companies, or increase in the value of Other Allowed Investments) less than 80% of the Total Fund Value of a PEIF consists of Private Equity Investments, an application can be made to the CMB to request a one (1) year grace period to rehabilitate the ratio. If the ratio cannot be rehabilitated at the end of such one year grace period, the PEIF should terminate its investment activities and deregister with the Trade Registry office within two years.

If the reason the Total Fund Value amounts to less than 80% at the end of an accounting period is because of a full exit from investments or the bankruptcy of the companies invested in, an application can be made to the CMB requesting a two (2) year grace period to rehabilitate the ratio. The CMB has discretion to evaluate such requests. If the ratio cannot be rehabilitated at the end of such two year grace period, the PEIF should terminate its investment activities and deregister with the Trade Registry office within two years. However, the right to file such request can only be exercised once in any five year period (including the year such minimum ratio requirement fails to be met).

d. Non-permissible investments

PEIFs are forbidden from engaging in the following activities:

- investment in gold, other precious metals, commodities or derivatives where such assets are the underlying value;
- short sales;
- borrowing securities or borrowing to invest in securities; and
- derivative transactions, except for hedging their currency, interest rate and market risks (if such is specifically permitted in their Circular) and open position stemming from derivatives and such activities cannot exceed 20% of the Total Value of the Fund.

e. Limitations on the use of Leverage

PEIFs can receive credit in order to meet the fund needs for their activities or to bear the expenses of portfolios. The total amount of those credits cannot exceed 50% of the total value of the PEIF. Where a PEIF receives credit, the founder should notify the CMB and investors (Unit-holders), disclosing all information, such as amounts of loan and interest and, credit receipt and reimbursement date, within 30 days following the end of the fiscal year.

PEIFs can use up to 50% of their total value as leverage.

X. Dividend Distributions

PEIFs may distribute dividends as determined in their ICs. Thus, it is possible in a Turkish PEIF to set out a distribution waterfall which provides that the proceeds from investments are paid in order of tiered priority. Although certain common approaches prevail in international market practice, Turkish rules remain flexible in order to allow for negotiation on the layering of waterfall tiers and the apportionment of distributions among them, which must reflect the agreed-on economics and have the potential to lead to wide variety of options. Accordingly, within the Circular, IC and IA, the waterfall distribution can be designed based on specific needs.

Distribution waterfall can freely be determined

In this context:

- All *capital contributed* for a particular investment can be returned to the QIs who provided it prior to any other distributions made from the proceeds of that investment. This tranche can be expanded to require a return of the portion of unrelated investments that have been permanently written down, all unreturned invested capital in previously realized investments, and all unreturned contributed capital.
- Following a return of capital contributions, in order to guarantee investors a minimum return on their invested capital before profits are shared with the Founder and/or the manager, a preferred return commonly known as a *hurdle* on the capital contributions (at rates that can freely be determined) can be distributed.
- It is possible to grant an entitlement to the Founder and/or the manager for profit participation (also known as *carried interest*, carry or a success fee) and *catch-up* tranche for, inter alia, a set percentage of profits. In this context, a Performance Fee - based on (i) dividend and/or interest receipts from Private Equity Investments or (ii) capital gains upon exit from Private Equity Investments - can be paid by the PEIF in the form of dividends to a privileged unit-holding Founder and/or the manager. The percentage, timing and calculation methodology of the carried interest and catch-up distribution must be set out in the Circular, IC and IA. The regulations do not impose any specific methodology e.g., deal-by deal carry (American style), deal-by-deal carry with loss carry forward (Clawback), or back-end loaded carry (European style) for calculating the carried interest.
- It is possible to arrange the distribution waterfall splits over the residual profits in accordance with the rates determined in the Circular, IC and IA.

Restriction on guarantees

Because of the restrictions on using PEIF assets as collateral, a PEIF cannot provide a parental guarantee for the debt obligations of private equity companies that are in its portfolio. Thus, if an investment requires a parental guarantee, as is often the case in private equity companies financed by project finance, alternative financing solutions must be utilized.

XI. Protection of Fund Assets

Assets of PEIFs:

- are separate from the assets of their Founder, Custodian and/or Portfolio Manager;
- cannot be pledged or otherwise used as collateral for any reason, other than making borrowings or hedging transactions for the account of the fund (to the extent based on the Internal Circular and the Issuance Document, borrowing/hedging on behalf of the fund is allowed); and
- cannot be disposed of, confiscated, be the subject of an interim injunction or included in bankruptcy estate for any other purpose, including collection of public debts even upon transfer of management or supervision of the principal and the custodian to public authorities.

XII. Custodian

Assets of the PEIF should be monitored in accordance with provisions of the Communiqué on Custodianship of Portfolios. Documents, records and information of both a tangible and intangible nature shall be maintained by the portfolio custodian. In the framework of the Agreement of Safekeeping, all necessary information shall be communicated to the Portfolio Custodian within 10 days following investment. The custodian shall maintain the information, belongings, documents and records of the assets in the portfolio of a PEIF which cannot be kept physically or in dematerialized form.

XIII. Supervision of PEIFs

All accounts and operations of the Founder in relation to PEIFs are subject to the supervision of the CMB. In addition, whenever deemed necessary, the CMB may request information, irrespective of reporting dates as determined by the Communiqué.

XIV. Reporting and Disclosure

a. Periodic Reports

PEIFs must prepare their periodic reports and financial statements and send them to the CMB and investors in accordance with the rules on financial reporting concerning securities mutual funds.

Accordingly, PEIFs shall prepare the following financial statements, liability statements and portfolio reports (price report and portfolio distribution report):

- Financial statements should be prepared on an annual basis
- Valuation reports (must be attached to financial statements)
- Price reports should be prepared on a quarterly basis¹⁶, and
- Portfolio reports should be prepared monthly.

b. Disclosure of Private Equity Investments

Contracts regarding Private Equity Investments, share transfer agreements, copies of stock ledgers of invested companies, articles of association or Circulars as well as other documents regarding organizations established abroad for the purpose of collective investment shall be submitted to the CMB within 15 business days following the investment.

The CMB may request information and documents regarding Private Equity Investments from the Founder and/or the manager, and the custodian, at its discretion and at any time.

The Founder and the manager shall also inform the shareholders of information related to Private Equity Investments within 15 days after the investment has been carried out.

¹⁵ PEIFs are exempt from disclosing financial statements to the public. Financial reports should be sent to the CMB within 60 days following the end of the accounting term, and sent to investors within 10 days.

¹⁶ Price reports should be sent to the CMB within 10 days from the last day of each quarter.

PEIFs, which disclose unit price more than once in an accounting period, are also obliged to prepare a six-month interim financial statement.

XV. Termination and Liquidation

PEIFs terminate on the date specified in the Circular. However, the founder may apply to the CMB for an extension, provided there is a relevant provision in the Circular.

XVI. CMB Fee

PEIFs make quarterly Regulatory Fee payments to the CMB. The fee amount is 0.005% of a fund's Total Asset Value, which shall be calculated by the Founder as of the last working day of each quarter and shall be approved by the custodian. The founder shall make the fee payment and submit payment receipts as well as fee calculation tables to the CMB within ten days after each quarter. However, from 2017 to end of the 2020, CMB fee will be applied as **0% for PEIFs**.

XVII. Taxation of PEIFs

The income of a Turkish PEIF is fully exempt from corporate tax. Moreover, the corporate tax exempt income of a PEIF is subject to 0% withholding tax. There is no further withholding taxation upon dividend distributions/redemptions to/by QIs of PEIFs.

PEIFs are exempt from corporate tax





Distributions from PEIFs are subject to 0% withholding tax

XVII. Taxation of PEIF Investors¹⁷

For Turkish tax purposes, cash dividend receipts (e.g., periodic) from PEIFs, cash proceeds from returning the Units to the Founder (redemption), and gains from the sale of Units are all subject to withholding tax.

Individual Investors

For resident individual QIs, the withholding tax rate is 10%. This is the final taxation and therefore such income/gain is not subject to declaration in the annual income tax return unless it constitutes a commercial (business) income. Furthermore, Private Equity Reserves (explained below) can be deducted from annual income declared by the annual tax return up to 10% of the income declared during the calculation of income tax base¹⁸.

For non-resident individual QIs, 10% withholding tax on distributions from PEIFs is the final taxation and the non-resident individual investors are not required to make any filing.

Corporate Investors

For resident corporate QIs (including non-resident corporate taxpayers that have a permanent establishment, such as a branch office in Turkey), the withholding tax rate is 0%. Gains from the sale of Units are subject to ordinary corporate taxation. However, income from PEIFs are exempt from corporate tax. In other words, corporate QIs will benefit from the participation exemption with respect to their investment incomes from Turkish PEIFs. Private Equity Reserves (explained below) can be deducted from annual income declared by the annual tax return up to 10% of the corporate income tax base of the relevant year and 20% of their equity.

For non-resident corporate QIs, 0% withholding tax on distributions from PEIFs is the final taxation and the non-resident investors are not required to make any filing.

Tax Subsidy - Private Equity Reserves

There is a special tax subsidy provided for investors in a Turkish PEIF.

Under the Law No:6322, individual and corporate tax payers (including non-resident corporate taxpayers that have a permanent establishment, such as a branch office in Turkey) are allowed to reserve a special fund, Private Equity Reserve (PER), from their annual income to be invested in Turkish PEIFs, up to 10% of their annual taxable income or corporate tax base of the relevant year and 20% of their equity. The PERs can be deducted from corporate or income tax base as long as such capital investment is actually made in a PEIF until the end of the year in which such PER is reserved. PER cannot be used for any other purpose, withdrawn, distributed to shareholders or repatriated. Moreover, in case the units in a PEIF are disposed, such amount should be re-invested within 6 months following such disposal. Otherwise, taxes will become due at the end of the 6-month period following the disposal.

Income received from PEIFs are exempt in the hands of corporate QIs

QIs may enjoy tax subsidies for their investments in PEIFs

¹⁷ The following section is based on the Draft Guidance released by the Revenue Administration in March 2017.

¹⁸ Mentioned subsidy can be benefitted by income tax payers who are required to keep their records on the balance sheet basis.

Gündüz Şimşek Gago Attorneys at Law ('GSG Attorneys at Law') provides solutions for a wide range of legal issues, from incorporation to complex structuring alternatives for domestic and multinational clients in a wide range of industries. GSG Attorneys at Law brings to be table its experience in corporate law, tax and customs dispute resolution and finance law with a specialized teams of attorneys.

At GSG Attorneys at Law, we create experienced and industry focused teams for our clients. We provide legal services in all areas of the law to a diverse range of clients across a multitude of industries.

Our Finance Law Team



Umurcan Gago

Gündüz Şimşek Gago Attorneys at Law
Partner

+90 (212) 326 6098

umurcan.gago@gsg hukuk.com



Alper Onar

Gündüz Şimşek Gago Attorneys at Law
Attorney

+90 (212) 326 6311

alper.onar@gsg hukuk.com



Pınar Tatar

Gündüz Şimşek Gago Attorneys at Law
Attorney

+90 (212) 326 6671

pinar.karamahmutoglu@gsg hukuk.com

Gündüz Şimşek Gago Attorneys at Law ('GSG Attorneys at Law ') provides solutions for a wide range of legal issues, from incorporation to complex structuring alternatives for domestic and multinational clients in a wide range of industries. GSG Attorneys at Law brings to be table its experience in general law and tax and customs dispute resolution with a specialized team of 43 personnel,including 30 attorneys.

At GSG Attorneys at Law, we create experienced and industry focused teams for our clients. We provide legal services in all areas of the law to a diverse range of clients across a multitude of industries.