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Capital Markets | Turkey | November 2021

A NEW RESOURCE FOR START-UPS: DEBT-BASED CROWDFUNDING

Crowdfunding entered into Turkish law through Article 35/A which was added to the Capital Markets Law in 2017. The legal basis for crowdfunding was established through this Article, and the Capital Markets Board (the "**Board**") was authorized to make secondary legislation on this subject. Subsequently, the Communiqué on Share-Based Crowdfunding (III-35/A.1) (the "**Former Communiqué**") was published by the Board in 2019.

In the Former Communiqué, only share-based crowdfunding activity was regulated, and debt-based crowdfunding activity was excluded from the scope. However, the current Crowdfunding Communiqué (III-35/A.2) (the "**Current Communiqué**") was published in the Official Gazette on 27 October 2021 to amend the Former Communiqué. Based on the Current Communiqué, debt-based crowdfunding activity which, in fact, has its legal grounds in Article 35/A of the Capital Markets Law, was brought into practice. Upon the Current Communiqué coming into force, entrepreneurs and start-up companies will be able to raise funds in exchange for shares or debt instruments through crowdfunding platforms.

1. Definition of Debt-Based Crowdfunding

Debt-based crowdfunding is a type of a peer-to-peer funding model that is widely used, especially in the United States, by start-ups who want to access lower-cost, quick and easy capital without having to navigate through the complicated procedures of traditional banks. However, the peer-to-peer funding model is not in high demand in Turkey due to various limitations in both private law and public law legislation.[1] Therefore, an important step has

[1] In accordance with the consumption loan regulations of the Turkish Code of Obligations, it is possible to lend a certain amount of money in return for an interest rate to be determined by the parties provided that certain conditions are met. However, if the relevant interest rate exceeds certain thresholds, there is the risk of usury, which is a crime under the Turkish Penal Code.

been taken towards popularizing the use of peer-to-peer debt instruments by including debt-based crowdfunding activities in the Current Communiqué.

As per the Current Communiqué, debt-based crowdfunding involves collecting money from the public through crowdfunding platforms in exchange for debt instruments to provide the funds needed for a project or start-up company. In the Current Communiqué, a debt instrument is defined as a security that is sold by the entrepreneur or by the start-up company through platforms, for which the funded company is referred to as the debtor, and which is based on the principle of repaying the nominal value to the investor in instalments until the due date.

Debt-based crowdfunding is an alternative method that can be applied especially by technology-oriented entrepreneurs and start-up companies in Turkey.

2. Limitations of Debt-Based Crowdfunding

The Current Communiqué substantially limits the freedom of peer-to-peer lending practices in order to create a safe environment for debt-based crowdfunding activity. Prominent features among these limitations are as follows:

- Debt-based crowdfunding can only be affected through the purchase and sale of debt instruments defined within the scope of the Current Communiqué. Contracts such as debt and loan agreements, as well as the purchase and sale of other capital market instruments, are excluded from the scope of debt-based crowdfunding activity.

- Publicly held partnerships and issuers with debt instruments that have not been redeemed as of the date of application to the crowdfunding platform, as well as companies in which publicly held partnerships, capital market institutions and issuers with debt instruments that have not been redeemed as of the date of application to the crowdfunding platform have significant influence[2], cannot raise funds through debt-based crowdfunding.

- Entrepreneurs and shareholders in the start-up company at the start date of the campaign period who will have a significant influence on the funded company cannot transfer their shares in the funded company until the date of the redemption of all debts arising from the debt instrument sold to investors during the campaign period, save for cases where the share transfer takes place due to inheritance, inheritance allotment, property regime provisions between spouses, compulsory execution, or where the share transfer is made to qualified investors or carried out between themselves.

- Maximum thresholds have been set for individuals who are not qualified investors in terms of investments to be made through debt-based crowdfunding. These individuals

[2] According to the Current Communiqué, having significant influence is defined as being a shareholder that directly or indirectly represents 10% or more of the capital or voting rights, or which has privileged shares giving the right to be represented on the board of directors even if the shareholding is below such percentage.

will be able to invest a maximum of TRY 20,000 in a single project through debt-based crowdfunding activity and will be able to invest a maximum of TRY 50,000 in a calendar year. The maximum investment allowed in a calendar year can be increased up to TRY 200,000 provided that certain conditions are met. The funds collected from investors in exchange for the debt instrument must be paid in cash in their entirety.

- Interest and other similar returns, maturity and payment conditions for the debt instrument to be issued by the entrepreneur and/or the start-up company, will be determined by the investment committee and the entrepreneur or the start-up company and will be announced on the information sheet on the platform. Funds cannot be collected with an interest rate or other similar return rate that is lower than the one stated on this information sheet. The interest rate or other similar return rate to be determined for the debt instrument cannot exceed 50% of the weighted average of the interest rates determined one day prior to the campaign period start for two government domestic debt securities that are the closest to the debt instrument maturity, one with a maturity shorter than the debt instrument, and one with a maturity that is longer than the debt instrument. The debt instrument maturity can be as much as five years. In addition, debt instrument repayment obligations will not be immediately fulfilled on the maturity date, and certain limitations will apply to payments made prior to the maturity date.

- An entrepreneur or a start-up company may collect funds based on debt-based crowdfunding via crowdfunding platforms through a maximum of two campaigns in any twelve-month period. The amount of funds that can be collected in this period cannot exceed the issue limit, which is exempted from the obligation to prepare a prospectus and announced by the Board every year. In any event, the amount of funds to be collected via debt-based crowdfunding by the entrepreneur or the start-up company cannot exceed 50% of the discounted value of the future cash flow that is included in the credibility report of the proposed project at the date of signing the credibility report.

- The revenues generated during the maturity period of the funded project will be used primarily for the payments to the investors invested through crowdfunding. Except for the borrowings realized within the scope of the project as specified in the information sheet in advance, the funds collected through debt-based crowdfunding cannot be used for payment of debts that arise from projects other than the funded project or other debts. However, it is possible to raise funds through debt-based crowdfunding to meet project-based working capital needs.

In addition, crowdfunding platforms can participate in individual participation investor networks, in practice known as "angel investor networks," which are accredited in accordance with the Regulation on Individual Participation Capital and established as joint stock companies. Thus, the intention is to create an organic bond between start-ups and angel investors, so that the process of funding progresses quickly despite all of the limitations.

3. Conclusion

Peer-to-peer funding has been a highly preferred practical method of raising capital in some countries such as the United States, which has so far been the epicentre of numerous technology initiatives, as well as China, which has encouraged the rapid development of this industry. On the other hand, some countries are distant to this method on the grounds that peer-to-peer funding activities are more risky than traditional funding activities. Yet, since the Current Communiqué has been accepted, peer-to-peer funding activity in Turkey has been solidified within the context of crowdfunding and the peer-to-peer lending process will move to a regulated level.

Debt-based crowdfunding will enable enterprises that cannot access funds easily and quickly due to the procedures imposed by banks, or which provide funds with high interest rates as a result of the belief that start-ups, at the idea stage, pose a high risk- to access the funds more easily. In addition, since debt-based crowdfunding is carried out through crowdfunding platforms, it will be easier for the entrepreneur and the investor to meet, and a transparent bond will be established, as the investor can follow the entire funding process in real time through the platform.

On the other hand, although, according to the Current Communiqué, the credibility of the entrepreneur will be investigated to ensure the maximum security, risks such as the failure of the entrepreneur and/or technical problems during the investment processes may still be experienced within the scope of the debt-based crowdfunding activity.

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