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WARRANTS: HIGH-RETURN SECURITIES

By Serra S. Hızıroğlu & Nazlı Çapan

This briefing note aims to summarize the legal framework of the warrants including its filing and trading process in Borsa Istanbul A.Ş. and taxation principles based on the main piece of legislation regulating this subject, Communiqué on Warrants and Investment Institution Certificates, numbered VII-128.3 (the "Warrant Communiqué"); and the Communiqué on Foreign Capital Markets Instruments, Depository Certificates and Foreign Investment Fund Shares, numbered VII-128.4 (the "Foreign Instruments Communiqué"), published by the Capital Markets Board of Turkey ("CMB").

Warrants are capital markets instruments that give the holder the right, but not any obligation, to buy (call warrant) or sell (put warrant) underlying assets, indices, stocks (shares of companies listed or to be listed), or other indicators such as commodities or precious metals, at a certain price, quantity, and on or until a specific maturity date.

As an investment tool in Turkey, the warrant is relatively new, as the very first listing of Turkish warrants was made in August 2010 on the Turkish stock exchange (namely Borsa Istanbul), and these instruments have been traded since then. In fact, warrants are becoming more attractive to Turkish investors every day, because investors must invest only a small amount of capital rather than buying the underlying itself at a higher cost. That being said, warrants also provide control of different stocks at one time using less capital. This is a good reason for investors to put warrants in their portfolio instead of the stock itself.

As per Turkish legislation, warrants are classified as "partnership warrants" and "investment institution warrants." In the case that warrants are issued by companies (stocks of companies listed or to be listed), such warrants are referred to as "partnership warrants." In the case that warrants are issued by foreign or local banks and brokerage firms, such warrants are referred to as "investment institution warrants." Because partnership warrants are not traded in Turkish capital markets, unlike other global markets, this briefing note will focus on the investment institution warrants issued in Turkey, which have been commonly traded for about 6 (six) years in the respective market of Borsa Istanbul.

I. UNDERSTANDING INVESTMENT INSTITUTION WARRANTS

To buy an investment institution warrant, the investor makes only a premium payment to the issuer, and the investor's risk is limited to this premium cost alone.

Because every warrant is attached to an underlying indicator, as mentioned above, the price of the warrant is affected by the performance of such underlying. With that being said, investors generally opt to invest in warrants when they expect price movements on the underlying indicator and thus to gain capital from such movement. Given this approach, investors prefer to invest on call warrants when they expect the price of the underlying to rise on a future maturity date. For example, if the price of a common stock is expected to increase by the maturity date of such call warrant, the investor will magnify its gain by acquiring such stock at a lower price on the maturity date.

Put warrants, on the other hand, attract investors when the price of the underlying is expected to fall. For example, if the price of a common stock is expected to decrease by the maturity date of such put warrant, the investor will magnify its gain by selling such stock at a higher price on the maturity date. It is worth noting that, in the case that the market price of the underlying is more profitable for investors than strikes determined by the issuer on the maturity date, contrary to the expectations, then such warrant's value will become zero and the investor's risk will be limited to the premium payment made to the issuer.

II. COMPARISON BETWEEN WARRANTS AND OPTIONS

Warrants are generally defined as securitized options and hence share similarities with options in the sense that both enable investors to benefit from the price movements of the underlying without purchasing the underlying itself but rather the warrant or the option alone. In other words, both warrants and options represent a right and entitle their holder to buy or sell a certain amount of underlying at a predetermined price on or before the specified date. Beyond this main similarity, certain differences may be listed as follows:

- Warrants are capital markets instruments, whereas options are contracts.
- Warrants are issued in Turkey by local or foreign banks or brokerage firms. However, the party who is selling the options is considered the creator/issuer of the option, which means that there may be more than one party to create/issue the option, unlike with the warrant.
- Options are standardized contracts, but warrants are not necessarily standardized, as there are several warrants in the Turkish market diversified by maturity, settlement price, and type.
- Options are traded according to the principles of future market, whereas warrants are traded according to the principles of spot market.
- Margin calls may be associated with options, whereas warrants are not subject to margin calls in trading, since all the responsibility is on the shoulders of the issuer.

III. LEGAL FRAMEWORK FOR WARRANTS ISSUED IN TURKEY

The legal framework for warrant offerings in Turkey is drawn by the Capital Markets Board of Turkey (the "CMB"). Accordingly the legal basis of the warrants is regulated by the CMB through Capital Markets Law, numbered 6362 (the "CML"); Communiqué on Warrants and Investment Institution Certificates, numbered VII-128.3 (the "Warrant Communiqué"); and the Communiqué on Foreign Capital Markets Instruments, Depository Certificates and Foreign Investment Fund Shares, numbered VII-128.4 (the "Foreign Instruments Communiqué"). In addition, warrants are traded on the stock exchange in Istanbul (known as Borsa Istanbul A.Ş. and to be referred to as "Borsa Istanbul"); hence, certain trading and quotation principles/regulations of Borsa Istanbul (e.g. Listing Directive, Equity Market Directive) are applicable to warrant offerings in Turkey.

In a general sense, the Warrant Communiqué envisages the principles pertaining to warrant offerings in Turkey, such as requirements that must be carried out by the issuer, procedures that will be pursued in order for approval of offering documents by the CMB. It shall also be noted that the Warrant Communiqué paves the way for the relevant principles of Foreign Instruments Communiqué that shall be applicable in case the issuer is incorporated outside of Turkey. For matters that are not covered under the Warrant Communiqué, such as preparation of prospectus, financial statements to be incorporated into the prospectus, and public disclosures, relevant regulations of the CMB shall be applicable.

As per the Warrant Communiqué, warrants are required to be sold to investors in Turkey through the brokerage of authorized institutions, and listed and traded in Borsa Istanbul on the basis of market making activity. The general principles applicable to warrant offerings, among others, are set forth under the Warrant Communiqué as follows:

- The maturity of the warrants to be issued shall not be less than 2 (two) months and more than 5 (five) years.
- The sale period of warrants is determined by the issuer, without exceeding the maturity.
- The first trading date of warrants is accepted as the maturity starting date.
- The nominal value of warrants cannot be less than 0.01 TRY (bir kuruş).
- Issuers shall not use shares representing their own capital as an underlying asset.
- The cash settlement principles must be applied in issuance of warrants where underlying asset or indices are one of the assets, or indices other than a share included in the BIST-30 index or a basket composed of more than one share included in the BIST-30 index.
- Issuance of warrants is made in dematerialized forms, and issuers are required to be members of MKK (Central Registry Agency).
- The settlement of warrants is either in the form of cash settlement or dematerialized delivery.

IV. MARKET MAKING AND CREDIT RATING

In Turkey, warrants can be issued by local or foreign banks and brokerage firms. In the event the issuer is a foreign bank or a brokerage firm, such bank or brokerage firm is required to make a market-making arrangement with a local brokerage firm in order to conduct the issuance through Borsa Istanbul. In such a case, the issuer will carry its position, whereas the referred local brokerage firm will be responsible for making the necessary applications and announcements regarding the issuance and offering documents in Turkey.

In order to issue warrants, the issuer, regardless of whether it is local or foreign, shall have a long-term credit rating note, which should be no less than the highest first three steps of investable level determined by independent rating agencies. Even though this rating note is required for both local and foreign issuers, foreign issuers face certain difficulties in meeting these grades based on the fact that such rating of foreign issuers is made by foreign credit rating agencies, which have high global standards that are quite challenging to meet, whereas local issuers are subject to the local grading system of credit rating agencies. Such difference in rating standards may create unfair outcomes, to the detriment of foreign issuers. This is why foreign issuers keep consulting with CMB to find a middle-way solution. In the case where the bank or brokerage firm domiciled in Turkey is not granted the referred rating note, then such institution may only issue warrants by providing the guarantee of a third bank or brokerage firm to cover its liabilities and obligations.

During the CMB filing, the issuer shall submit to CMB the up-to-date rating documents obtained from rating agencies, and such rating agency regularly reviews and revises the information constituting the basis of its rating. In case the rating of the issuer or guarantor falls below the referred rating, then the warrant offering will be stopped by the issuer. If the issuer fails to stop or delays in stopping the issuance, such issuance will be directly stopped by the CMB, and the CMB will not permit issuance of new warrants.

V. CMB FILING

Local or foreign banks and brokerage firms intending to issue warrants in Turkey shall make a filing to and obtain the approval of the CMB for the prospectus and offering documents to be disclosed. With CMB filing, the issuer aims to secure the approval of CMB with respect to the issuance ceiling for the upcoming 1 (one) year term in relation to the quantity of warrants to be issued for that year. Once the prospectus application is approved by the CMB for a validity term of 1 (one) year, issuer shall apply to the CMB for approval on offering documents, namely "capital markets instrument note" and "summary," 5 (five) business days prior to each issuance. Each issuance will be made within such 1 (one) year term without exceeding the issuance ceiling.

VI. LISTING AND TRADING OF WARRANTS

Warrants offered to the public in Turkey are traded under the Borsa Istanbul Collective Investment and Structured Products Market (formerly known as the Collective Products Market), and such warrant offering is conducted in accordance with the selling method applicable at the referred market.

As also referred herein above, the trading of warrants in Borsa Istanbul is conducted on the basis of market-making activity, and such activity is formalized by enacting an agreement between the issuer and the market maker. For this purpose, the market maker, which will be a brokerage firm holding a "dealing on own account" license granted by the CMB and a member of Borsa Istanbul, is required to give quotations continuously for a more liquid and well-regulated market.

In order for warrants to be traded in the Borsa Istanbul Collective Investment and Structured Products Market, a listing (kotasyon) application shall be made by the issuer or the market maker to Borsa Istanbul simultaneously with the CMB filing.

Following the approval of the listing application by Borsa Istanbul, the issuer or market maker shall submit the offering documents (capital markets note and summary) to the CMB and submit the required documents to Borsa Istanbul prior to each referred issuance in order for warrants to be traded in Borsa Istanbul (trading application).

VII. GENERAL TAXATION PRINCIPLES

In general tax practice, income generated from the holding, redemption, and disposal of warrants traded on Borsa Istanbul are subject to withholding tax under Temporary Article 67 of the Income Tax Law ("Temporary Article"). According to such regime, banks or brokerage firms operating in Turkey are required to make a withholding, on a quarterly basis, on the income of their customers arising from transactions effected through such banks and brokerage firms on behalf of their customers. As of today, the statutory withholding tax rate is 15 percent; however, reduced tax rates of 0 percent or 10 percent are applicable to certain categories of income, which is determined by the Council of Ministers.

The good news is that investors benefit from the incentive given by Article 1 of the Council of Ministers Decision numbered 2010/926, either to full-fledged or limited taxpayer real persons or legal entities, that reduced the withholding tax to 0 percent as of 1 October 2010, which is applicable to their income generated from shares including futures and options and intermediary institution warrants related to shares and share indices traded on Borsa Istanbul.

More specifically, Income Tax Communiqué No. 282 issued by the Department of Treasury sets forth that the withholding tax will be 0 percent for the incomes acquired from warrants traded on Borsa Istanbul relating to shares and share indices. However, incomes generated from other warrants that are not in this scope will be subject to withholding pursuant to the Temporary Article.

In addition, warrants are not subject to stamp taxes, statutory fees and duties, or similar charges in Turkey, whereas the documents containing undertakings (agreements, etc.) executed in relation to the said warrants may be subject to a stamp tax as per the Stamp Tax Law. Further, please note that according to the explanation made in Section (E) of the General Communiqué of the Ministry of Finance on Expense Taxes, Serial No: 89, the actions taken regarding the warrants that are traded on Borsa Istanbul and the amounts received as a result of such actions are exempt from Banking and Insurance Transactions Tax pursuant to Article 29 (p) of the Expense Tax Law No. 6802.

VIII. FINAL WORDS

Warrants have been traded in global markets (i.e. the United States, the European Union) for a long time, and the popularity of warrants has increased with the emergence of new market players trading in the market. In contrast to the global position, Deutsche Bank and İş Yatırım are the only market players acting permanently in the Turkish warrant market as issuers, and so the market is kept liquid, organized, and deep. Despite this fact, market players put effort into keeping this market alive by issuing new types of warrants, such as spread warrants and turbo warrants.

Due to the growing demand for warrants, and particularly for stock warrants, current market players create warrants based on the same underlying with different features (exercise price, maturity, etc.) in order to attract the investors trading in the local market. More than that, the underlying of warrants is diversified as of today with foreign stocks listed in the Nasdaq 100, S&P 500, global indices, and so on. Beyond this fact, investors in Turkey also seek to invest in foreign commodities, precious metals through warrants in the near future, and current market players are expected to create new warrants with such underlying(s).

Our final words are that the current position of Turkish warrants becomes more attractive for investors residing in Turkey. With the support of leading market players and the cooperation of Borsa Istanbul, the Turkish warrant market promises to improve with the contribution of other possible market players, with the ultimate aim of making Istanbul a real financial center.

CONTACTS

Serra S. Hızıroğlu, Partner
T: +90 212 365 9626
shiziroglu@eryurekli.com

Nazlı Çapan, Senior Associate
T: +90 212 365 9633
ncapan@eryurekli.com

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