RATING-BASED INDEXING OF THE ISTANBUL STOCK EXCHANGE:

LESSONS FROM ITS FAILURE, NOVO MERCADO'S SUCCESS TO ADVANCE CORPORATE GOVERNANCE REFORMS

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ABSTRACT

The authors examine the reasons why the Istanbul Stock Exchange's initiative to promote better corporate governance among their listed companies has failed to take off, in contrast to the Novo Mercado's success. After comparing the similarities and differences between Brazil and Turkey, the authors link Brazil's success to the influence of a broader range of investors (including pension funds and foreign investors) than is the case in Turkey. Further, "the collaboration of the private and public sectors, under the leadership of private actors, was a distinct feature of the Novo Mercado," the authors write. A weak legal foundation, few (if any) effective drivers of change, and the lack of sufficient incentives for the private sector are additional factors explaining why many companies in Turkey have yet to adopt corporate governance reforms. Having both a policy-making framework and policy reforms in place to support corporate governance reform is a key determinant of success, as the Novo Mercado experience illustrates.

INTRODUCTION

In the last 10 to 15 years, developed and emerging economies with weak corporate governance regimes have seen their securities markets lose listings and, hence, liquidity to international exchanges. Consequently, some exchanges began creating new "investor friendly" tiers and listing requirements. Others enacted reforms, including corporate governance codes, to protect minority shareholders. Most of these reforms chose "comply or explain" voluntary provisions and/or voluntary corporate governance codes, which provide more flexible, market-led regulations. Both reform efforts – voluntary listing tiers and codes – seek to share the control premium with minority shareholders as a means of encouraging equity investments.

In this commentary, we compare the objectives, processes, and outcomes of the different approaches adopted by the São Paolo Stock Exchange (BOVESPA) and the Istanbul Stock Exchange (ISE) for differentiating the "better governed" firms that have listed on their respective exchanges.

Maria Helena Santana's case study on the Novo Mercado of BOVESPA and Petra Alexandru's commentary on the Transparency Plus Tier (T+ Tier) of the Bucharest Stock Exchange (BVB) inspired us to review ISE's decision to reject the Novo Mercado model and, instead, employ the Corporate Governance Index (CGI) in Turkey.

Launched in late December 2000, the Novo Mercado attracted more than 30 companies within five years. In contrast, since its announcement in 2005, the CGI has yet to interest the five qualified companies needed to start calculating the index. The main reason is that ISE-listed companies lack interest in complying with a comprehensive list of corporate governance provisions.

BRAZIL AND TURKEY: THEIR ECONOMIES, FINANCIAL MARKETS

Brazil and Turkey share similar development patterns and "democratic" traditions. Both belong to the French civil law tradition and suffer from an inefficient judiciary, weak enforcement, and the lack of a private litigation tradition.

Over the last 20 years, Brazil and Turkey have been subjected to similar economic vulnerabilities, resulting from a series of domestic and international shocks that led to suspension of democratic processes. Both countries had to cope with domestic debt, prolonged periods of both high inflation and unemployment, and failed efforts to achieve sustainable growth. Highly unequal income distribution remains a pressing problem in both countries.

Modern Turkey's Origins

Modern Turkey was founded in 1923 from the remnants of the Ottoman Empire. Until 1945, the state was the major economic player and subsidized private-sector development. A pro-market policy started to emerge after 1945, but the state remained heavily involved in its country's economy. In general, intervention by Turkey's government over the past years was oriented towards short-term, palliative measures instead of much-needed, sustainable solutions to the economy's structural problems. This led to an evolving relationship between the state and the business sector—one that generally lacked trust.

In 1980, Turkey's import substitution policies were replaced by an export-led stabilization and structural adjustment program. This program included the liberalization of capital markets, which was carried out between 1980 and 1989. The Capital Market Law was enacted in 1981, followed by the establishment of the Capital Market Board of Turkey (CMBT) in 1982.[1] After five years of preparation, the ISE was reorganized and reopened in 1986.

From 1990 to 2000, Turkey was hit by economic crises, during which time the inflation rate averaged 75 percent. Following the long-awaited European Union decision granting official candidate status in 1999, Turkey's worsening current account and the likelihood of a liquidity crisis forced the government to launch a major stabilization program with a stand-by IMF agreement. In late 2000, Turkey was eventually hit by a banking crisis, which was caused by liquidity problems, outright fraud, and related-lending issues. The IMF continued to support Turkey's reforms with subsequent agreements signed in 2001 and 2004. The developments after 2000 are summarized in this commentary's fourth section.

Prior to 2001, a long period of macroeconomic instability had reduced the probability of introducing corporate governance reforms in Turkey. Since 2001, the EU and the IMF both remained strong anchors for reform, which included restructuring the banking sector at a cost of US$43 billion. In 2004, acknowledging the reform's success, the EC recommended that the EU start accession negotiations with Turkey.[2] The prospect of a sustainable, stable economy encouraged the government to continue with public-sector reforms, focusing on accountability, transparency (leading to improvements in the audit capacity and framework), and efficient tax regulations. Complementing the ongoing structural reforms in the public sector, CMBT initiated and led the process to improve the governance standards of listed companies.

1 Despite having some operational independence, CMBT is a semi-governmental agency overseeing the ISE. ISE's structure is similar to that of BOVESPA on paper. It is owned by its members and governed by its general assembly. However, ISE's operational independence has been questionable due to subsequent interventions from the government through CMBT, especially on fiscal matters. For example, the state-controlled listed companies did not fully comply with the guidelines and the privatization tenders made no reference to the guidelines.

2 Inflation fell to historic lows, political interference lessened, and the institutional and regulatory framework was aligned more closely with international standards, an important change towards a stable, rule-based economy. See: M. Ararat and M. Ugur. "Turkey, Corporate Governance at the Crossroads" in Chris Mallin (ed), Handbook on International Corporate Governance, Cheltenham, Northampton: Edward Elgar, 2005.

Key Comparisons between Brazil, Turkey

In the early 2000s, the Brazilian equity market was characterized by relatively low liquidity, high costs of capital, and limited growth in new capital. Compared to its Latin American neighbors, Brazil's equity market was large, but market capitalization was concentrated in a small number of large companies.

A comparison of the Brazilian and Turkish financial markets is provided in Table 1, using time series data from 1990 to 2004. The ratio of stock market capitalization to GDP starts in 1990 at about the same level for both countries. While this ratio in Brazil exceeds Turkey's in most years since 1990, by 2000, the difference becomes substantial, averaging nearly 39 percent for Brazil and 24 percent for Turkey. On the other hand, there was substantially less trading in Brazil than Turkey, as is indicated in the third and fourth columns (Brazil 13 percent vs. 32 percent in Turkey from 2000 to 2004).

While a private bond market is virtually nonexistent in Turkey, this market's capitalization relative to GDP was about 10 percent of Brazil in the 1990s. The size of the public bond markets in both countries is much higher. Turkey has a slightly larger bond market relative to GDP in the last three years of the sample period (1990-2004). The other proxies for gauging the status of financial market development at that time are the financial institutions' ratios of private credit. (See Table 1.) These ratios suggest that Brazil has a more developed financial market. Both countries' markets, though, were flooded with public borrowing, resulting in very high interest rates.

There were relatively few IPOs in both countries. Turkey had on average 24 IPOs per year from 1990 to 2000, but this number is much lower (seven per year) after 2000. (See Table 2.)

Table 1: Structure of Financial Systems in Brazil and Turkey, 2003-2004

	Stock Market Capitalization / GDP		Stock Market Total Value Traded /GDP		Private Bond Market Capitalization / GDP		Public Bond Market Capitalization / GDP		Private Credit by Deposit Money Banks / GDP		Private Credit by Deposit Money Banks and Other Financial Institutions / GDP	
	Brazil	**Turkey**	**Brazil**	**Turkey**	**Brazil**	**Turkey**	**Brazil**	**Turkey**	**Brazil**	**Turkey**	**Brazil**	**Turkey**
1990	6.71%	8.50%	1.21%	3.87%	0.00%	0.37%	0.00%	5.11%		12.07%		13.02%
1991	7.24%	11.57%	3.29%	5.68%	0.00%	0.30%	0.00%	5.81%		12.76%		13.84%
1992	11.30%	8.11%	5.25%	5.15%	1.26%	0.53%	0.94%	7.70%	19.11%	12.76%	24.22%	13.85%
1993	16.51%	13.20%	13.11%	12.98%	3.36%	1.12%	7.41%	9.64%	22.92%	12.80%	27.64%	13.71%
1994	26.39%	22.89%	19.96%	16.69%	8.29%	1.28%	14.61%	13.18%	28.33%	12.48%	34.18%	13.39%
1995	24.10%	12.61%	11.25%	30.41%	10.89%	0.53%	17.93%	10.57%	30.11%	11.94%	36.80%	12.74%
1996	23.60%	14.07%	14.45%	20.35%	10.40%	0.37%	23.77%	12.92%	28.07%	15.04%	33.66%	15.86%
1997	29.30%	24.12%	25.00%	29.64%	9.90%	0.05%	29.89%	14.86%	27.52%	17.36%	32.40%	18.21%
1998	26.51%	23.79%	18.65%	34.23%	11.74%	0.03%	35.01%	16.80%	29.39%	18.21%	34.55%	19.08%
1999	36.79%	39.67%	16.50%	44.17%	15.21%	0.00%	49.82%	21.92%	29.19%	18.13%	35.13%	19.03%
2000	37.95%	46.38%	16.78%	89.95%	8.78%	0.00%	40.72%	24.65%	27.17%	17.99%	34.87%	18.77%
2001	40.98%	40.94%	12.81%	53.75%	9.91%	0.00%	50.69%	48.46%	27.25%	18.55%	35.58%	19.37%
2002	33.91%	22.38%	10.46%	38.41%	9.98%	0.00%	47.24%	48.24%	26.47%	13.46%	34.10%	14.26%
2003	35.64%	21.42%	11.94%	41.50%	9.40%	0.00%	41.45%	48.62%	26.69%	13.42%	34.31%	14.17%
2004	46.91%	27.72%	15.47%	48.68%	10.71%	0.00%	45.11%	51.65%	26.23%	16.40%	33.89%	17.09%

Source: IFS Statistics.

Table 2: The Development of the Stock Market in Turkey, 1990-2006

	Number of Listed Companies	IPOs	Trading Volume (Mn.$)	Funds raised through IPOs (Mn $)	ISE-100 Index $ based:1986=100)	Stock Market Capitalization (Mn. $)	Stock Market Capitalization/GDP
1990	110	35	5.85	985.31	642.63	18737	8.30%
1991	134	24	8.50	319.63	501.50	15564	10.71%
1992	145	13	8.56	94.42	272.61	9922	7.72%
1993	160	17	21.77	152.45	833.28	37824	13.14%
1994	176	25	23.20	270.48	413.27	21785	18.60%
1995	205	30	52.35	246.78	382.62	20782	13.59%
1996	228	25	37.73	167.92	534.01	30797	15.20%
1997	258	31	58.10	420.38	982.00	61879	24.17%
1998	277	20	70.39	383.35	484.01	33975	16.92%
1999	285	10	84.03	87.41	1654.17	114271	59.70%
2000	315	36	181.93	2809.53	817.49	69507	33.82%
2001	310	1	80.40	0.24	557.52	47689	39.00%
2002	288	4	70.75	56.5	368.26	34402	20.00%
2003	285	2	100.16	11.30	778.43	69003	27.00%
2004	297	12	147.75	482.58	1075.12	98073	31.00%
2005	304	9	201.76	1743.96	1726.23	162814	45.00%
2006	316	15	229.64	930.50	1620.59	163774	51.00%

Source: Istanbul Stock Exchange, Annual Factbooks 1990-2006

3 Silvia M. Valadares and Ricardo P.C. Leal. 2000. Ownership Structure of Brazilian Companies. Available at SSRN: http://ssrn.com/abstract=213409 or DOI: 10.2139/ssrn.213409 .

4 B. B. Yurtoglu, "Ownership, Control, and Performance of Turkish Listed Firms." Empirica 27, no.2 (2000): 193-222. B. B. Yurtoglu, "Corporate Governance and Implications for Minority Shareholders in Turkey." Journal of Corporate Ownership and Control no.1 (2003): 72-86.

5 Ararat, Orbay, and Yurtoglu (2006)

OWNERSHIP PATTERNS: DIFFERENCES, SIMILARITIES IN TWO PERIODS— THE 1990s AND 2000-2006

Both countries exhibit similar ownership patterns: businesses are organized into industrial groups and are largely controlled by families. Academicians Sylvia M. Valadares and Ricardo P. C. Leal analyze the direct and indirect ownership structures of listed Brazilian companies in 2000 and reported that[3]:

1) The ownership concentration is high, with the largest direct shareowner holding averaging 41 percent of equity capital.

2) There are frequent violations of the one-share-one-vote rule.

3) Both non-voting shares and cross-ownership structures are used to achieve this violation. However, the role of non-voting shares is much more pronounced in Brazil.

4) Corporations are the most common investor category at the direct level. Families turn out to be the ultimate owners.

Similar patterns have been reported for Turkey in 2000 (A detailed account is provided in Table 2.)[4]:

1) Ownership concentration in Turkey is similar to that of Brazil, with the largest direct shareholder averaging 47 percent of equity capital.

2) In Turkey, there are frequent violations of the one-share-one-vote rule based on the use of share groups, which can exercise privileged control rights collectively.

3) Voting privileges and pyramids are both used to bypass the one-share-one-vote rule. Pyramids are much more responsible for the wedge between voting and cash-flow rights.

4) Corporations and holding companies are the most common shareholder categories at the direct level. Families ultimately control about 80 percent of the listed companies primarily using pyramids.

Even as late as 2006, there is some evidence that the boards in both countries are ineffective and only play advisory roles.[5]

For all the above reasons, there is also evidence that both countries suffer from low valuations for their firms. This large discount is due to the concentrated shareholding structures and deviations of cash-flow rights from voting rights. There is a large premium for controlling blocs, indicating a high level of private benefits for the controlling stake and expropriation of minority shareholders.

While the similarities between the two countries are far more pronounced than the differences, select key differences can be of substantial importance from a corporate governance reform perspective.

One such difference concerns the identity of minority shareholders. Local institutional shareholders, mainly pension funds and mutual funds, owned significant minority stakes in Brazil. As of 2000, these holdings amount to a little less than four percent at the direct ownership level and to almost five percent at the ultimate level.[6]

While Brazil has a much longer history with privately managed pension funds, Turkey does not (they were introduced in 2000) so these funds play very limited roles. Table 6 provides an overview of pension-fund holdings using CMBT data. Pension funds controlled a portfolio totaling YTL295 million in 2004, with shares comprising about 13.32 percent of these holdings. The total portfolio increased to YTL2.7 billion in 2006, but the fraction in equity investments declined to 8.6 percent.

Foreign investors constitute an important investor category in Brazil. These investors have on average eight percent of the direct and 14 percent of the indirect holdings.[7] These percentages are much lower in Turkey, where foreign shareholders have sizeable stakes in only 20 of the 218 listed companies. (See Table 3.)

This difference is mainly due to the relatively early start of privatization in Brazil, which led to a significant presence of foreign investors in BOVESPA in the 1990s. In Turkey, privatization led to similar results only after 2003.

Another important difference between Brazil and Turkey is the existence of different mechanisms used to increase the wedge between cash-flow and voting rights.

6 Valadares and Leal, "Ownership Structure." (2000).

7 Valadares and Leal, "Ownership Structure."

Table 3: Ownership and Control Structure of Turkish Listed Companies

PANEL A: DIRECT OWNERSHIP

		Largest Shareholder			CR3 (Sum of the three largest shareholders)			Dispersed		
Identity	**Number**	**Mean**	**Median**	**Std.Dev.**	**Mean**	**Median**	**Std.Dev.**	**Mean**	**Median**	**Std.Dev.**
Holding Company	96	47.62	46.23	17.66	65.80	68.84	15.31	30.6	27.90	14.35
Non-financial companies	47	47.84	44.38	17.20	67.31	66.89	14.60	28.9	26.10	13.71
Financial companies	5	49.25	51.00	13.09	58.62	55.96	11.81	39.2	40.79	14.07
Families	42	34.11	28.20	22.64	52.22	54.10	24.20	38.3	29.30	25.96
Foreign companies	20	67.77	69.28	19.22	81.20	83.98	13.38	17.5	16.03	13.45
State	5	67.25	65.76	29.93	70.02	65.76	26.27	23	25.00	20.29
Miscellaneous	3	63.87	83.16	34.02	68.42	83.85	27.37	31.2	15.44	27.68
Total	**218**	**47.63**	**45.47**	**21.07**	**64.89**	**67.23**	**18.85**	**30.5**	**26.11**	**17.96**

PANEL B: ULTIMATE OWNERSHIP

		Voting Rights			Cash Flow Rights			Wedge		
Identity	**Number**	**Mean**	**Median**	**Std.Dev.**	**Mean**	**Median**	**Std.Dev.**	**Mean**	**Median**	**Std.Dev.**
Families	173	66.10	66.23	21.54	54.04	56.61	22.84	7.47	1.00	49.84
Foreign companies	21	67.30	70.00	20.73	65.31	68.56	19.67	1.04	1.00	0.16
State	7	65.83	55.62	22.57	65.83	55.62	22.57	1.00	1.00	0.00
Miscellaneous	17	65.35	65.57	19.42	42.56	34.49	22.84	2.18	1.75	1.95
Total	**218**	**66.15**	**66.30**	**21.20**	**54.61**	**55.92**	**22.98**	**6.23**	**1.00**	**44.44**

PANEL C: THE FREQUENCY OF DUAL CLASS SHARES AND CORPORATE CHARTER ARRANGEMENTS

Number of Companies with	N
One share one vote	125
Two types of shares with different voting rights	66
More than two types of shares with different voting rights	19
Special treatment in the distribution of earnings	24
Special treatment in the election of the board of directors	82
Special treatment in the election of the supervisors	41
Preemptive right to buy new issues of stock	13

As of 2001, the use of non-voting preferred stocks is common in Brazil, allowing controlling shareholders to exercise control with less than one-third of their cash-flow rights. Minority shareholders did not have voting rights at that time.

By comparison, controlling shareholders of Turkish companies use pyramidal structures and nomination privileges to increase their control. Most of the ISE-30 companies predominantly have common shares. Pyramidal structures are not common in Brazil, whereas non-voting shares are not common in Turkey. Panel C of Table 3 shows the frequency of multiple shares (which are not necessarily non-voting shares, but offer some privileges to controlling shareholders) and other privileges reserved for controlling shareholders in Turkey. In 66 of the 218 listed industrial companies, there are more than two types of shares, while the frequency and extent of pyramidal structures is much more pronounced. Non-voting "shares" do exist in Turkey, but they are not part of the equity. So-called "founder shares" are coupled with "vouchers," which allocate additional cash-flow rights to the founders without them having to provide an additional investment. In general, founder shares entitle the owners to a certain percentage of the company's profits, independent of whether the general meeting of shareholders decides to distribute dividends. The use of founder shares may partly explain the low-dividend performance of Turkish companies.

One can also observe some differences in the propensity of Brazilian and Turkish firms to list abroad. In 2000, significant Brazilian companies listed abroad, which pulled liquidity out of BOVESPA and led to contraction in the local market. That year, the volume traded on the US market by 28 Brazilian companies (representing 5.6 percent of the 495 companies total on the BOVESPA) amounted to one-third of the entire volume traded on BOVESPA. In contrast, the effect of foreign listings was much less significant in Turkey since there was only one large issuer on the New York Stock Exchange and another on the London Stock Exchange at that time.

Another important difference deals with de-listings at BOVESPA and ISE. It was possible to de-list from BOVESPA, which experienced a significant number of de-listings in the late 1990s. Turkey's stock-exchange regulations make it practically impossible to deregister from ISE.[8]

Yet another difference concerns the development of non-governmental initiatives in both countries. Whereas such initiatives date back to 1995 in Brazil with the founding of IBGC (Instituto Brasileiro de Governança Corporativa), similar efforts started much later in Turkey with the launch of TUSIAD's Corporate Governance task force in 2001, the Corporate Governance Forum of Turkey (CGFT) at Sabanci University in 2002, and the Corporate Governance Association (TKYD) in 2003.

CHANGES AFTER 2000: NOVO MERCADO – WHY OR WHY NOT?

As described above, ISE experienced problems similar to those faced by BOVESPA before its launch of the Novo Mercado. There were no IPOs, trading volume was at historic lows, and issuers were complaining about compliance costs. ISE was exploring the idea of encouraging IPOs by establishing a separate market for small to medium-size companies with *less strict criteria*.[9] A separate market tier with tighter corporate governance requirements did not appeal to ISE for the following reasons:

a) Only the largest and most liquid companies who target international institutional investors would be interested in, and capable of, complying with stricter criteria. The main market would be heavily discounted and dwarfed if these firms were to be excluded.[10]

8 This resulted in "listed" companies, whose traded shares diminished to less than one percent.

9 CMBT was not supportive of this idea.

10 The 30 companies that were considered to be the potential constituencies of a corporate governance segment constituted 80 percent of the market value

b) There were reputational risks; issuers might not be interested in the index since there were no explicit signs of interest from investors.

c) Operational difficulties and resource requirements for a separate market would be substantial; ISE and CMBT both had resource shortages.

When ISE considered the Novo Mercado, the approach was found lacking in two principal respects in 2000: first, its listing criteria seemed too simplistic; and, second, Novo Mercado had only one listing and did not appear to be a success.

The Corporate Governance Committee established by the CMBT had considered four alternatives to promote voluntary improvements in the governance of listed companies:

- indexing based on ratings by independent rating agencies;
- a separate market;
- indexing based on CMBT ratings; and,
- award systems.

CMBT wanted to act quickly. A separate market tier of the ISE would require a longer preparation period, whereas an index could be launched as soon as there was a sufficient number of qualifying companies. CMBT ratings qualification was not supported for various reasons: methodology development would need skills and expertise that CMBT did not have; and, maintaining the index would require permanent resources, including a substantial commitment of staff time.

By 2003, the credit-rating agencies Standard & Poor's and Fitch Ratings were actively promoting corporate governance scoring services in Turkey. Deminor, a Brussels-based corporate governance rating firm (later acquired by Institutional Shareholder Services), was also active in the market. CMBT opted to use independent rating agencies (or their licensees). This was considered to be a faster, less costly, and less risky approach than a separate market segment like the Novo Mercado.

CMBT's decision was based on the assumption that the corporate governance scoring methodologies would converge as the quality of corporate governance becomes an important investment criteria for global investors. CMBT believed that compliance with the Corporate Governance Guidelines would indicate compliance with internally accepted standards. Another assumption was that the Nationally Recognized Statistical Rating Organizations (NRSRO) would offer corporate governance rating services in Turkey.[11] Since NRSRO activities are strictly monitored by the U.S. Securities and Exchange Commission, local monitoring would not be needed. Furthermore, the qualified companies would appeal to global investors.

Subsequently, the NRSROs unanimously decided to incorporate corporate governance assessments into credit rating methodologies and stopped offering corporate governance scoring as a separate service. Based on various informal discussions with NRSRO representatives, our view is that corporate governance "ratings" exposed the rating agencies to significant reputational risks without an attractive return. CMBT responded by releasing the requirement of an "international rating methodology" for certifying rating agencies. Since then, two local agencies have been established.

Since the launch of the Corporate Governance Index and the 2005 decree, three Turkish companies commissioned corporate governance rating agencies. Isbank used Core in 2005, while both Dogan Yayin Holding and Vestel commissioned ISS in 2006 and 2007.

According to market participants, the three companies' scores did not have credibility for two reasons. First, all three companies received very high scores (8 – 9 out of 10), but the reports did not seem to capture the issues that mattered most to local investors. One reason explaining this outcome is the rating agencies' use of foreign analysts to meet CMBT's requirements. (According to the CMBT rating decree, analysts must be certified by passing a CMBT exam and they must have three years of corporate governance rating experience with an international firm. This sharply limited the pool of qualified local analysts.) The foreign analysts were not familiar with the local context. Their published reports could not capture the complex relations within Turkish business groups and the influence exercised by controlling shareholders through pyramidal structures and informal mechanisms since the guidelines are designed to focus on single companies. In fact, one of

11 In the US, the Securities and Exchange Commission (SEC) permits the use of credit ratings from certain credit-rating agencies for certain regulatory purposes. Those agencies whose ratings are permitted to be used for these regulatory purposes are referred to "Nationally Recognized Statistical Rating Organizations" (or "NRSROs"). The SEC grants NRSRO recognition, administers these agencies' registration, and surveils their activities.

the published corporate governance rating reports notes that their score reflects "compliance with the guidelines" and is not to be confused with a corporate governance rating.

Corporate Governance Guidelines Launched

ISE remained an observer when CMBT launched the Corporate Governance Guidelines in 2003. Based on the OECD's Corporate Governance Principles, these guidelines provide recommendations for listed companies' governance on a "comply or explain" basis. The guidelines consist of more than 100 provisions grouped under four headings: Shareholder Rights; Disclosure and Transparency; Board Responsibilities and Processes; and, Stakeholder Relations. CMBT's efforts were neither blocked nor wholeheartedly supported by the government[12] since the focus of the Turkish government's investment promotion strategy has been on attracting foreign direct investments.[13] Since the public initiative was poorly coordinated, the private sector remained skeptical. CMBT spent considerable effort to establish a private-sector dialogue, but they could only engage with salaried managers rather than the owner-managers (controlling shareholders). The process was not effective because consultation is not part of the Turkish political traditions. Further, there is a lack of trust between the state and the private sector, as explained earlier. Pension funds were just starting, foreign ownership in listed companies was negligible, and the media was not yet interested in corporate governance matters. The CGFT[14], a new initiative, was the main private entity that actively supported CMBT's efforts.

During the year following the guidelines' launch, the response from listed companies in adapting the voluntary principles was disappointing. Very few

companies made any reference to CMBT's guidelines in their 2003 annual reports. In order to improve compliance in 2004, CMBT introduced mandatory reporting

12 For example, the state-controlled listed companies did not fully comply with the guidelines, and the privatization tenders made no reference to the guidelines.

13 Unfortunately, the lack of coordination between public offices and agencies has been a persistent problem in Turkey. For example; while CMBT was busy with improving the regulatory framework for listed companies, the Banking Regulatory and Supervisory Agency (BDDK) was also working on improving the corporate governance regime of the financial institutions. Meanwhile, a committee established by the Ministry of Justice had been working on a draft Commercial Code for years. The cooperation among BDDK, CMBT, and the commission set up by the Ministry of Justice was limited. Nevertheless, the draft recognized CMBT's regulatory authority on corporate governance for all joint stock companies.

14 A research and advocacy center co-founded in 2002 by the Turkish Businessmen and Industrialists Association and Sabanci University.

based on a standard report template. Starting with the 2004 annual reports, listed companies had to outline how they were in compliance with CMBT's guidelines, using the CMBT template. The report had to explain which provisions the issuers had complied with and which ones they hadn't done so (the reasons why and the actions they planned to comply). Unfortunately, the quality of compliance reports in the 2004 annual reports and the guidelines' implementation were both disappointing, according to a CMBT survey. These efforts had created some awareness, but there were neither strong incentives nor sanctions to compel compliance.

The guidelines' legal foundation was weak. Although drafting of the modern company laws had started as early as 2000 in Turkey, the guidelines preceded modernization of the commercial code. The guidelines were envisaged as a road map for improvements in shareholders' legal protections. The draft Commercial Code, which was expected to be enacted in early 2006, introduced a completely new framework and pro-market approach for joint stock companies to support the guidelines. However, the draft was blocked by the opposition in parliament.[15]

In Brazil, banking reforms preceded the new Company Law (2001) and the voluntary corporate governance code (2002). Although the Company Law was subject to political interventions and changed considerably before enactment, it provided a better foundation for regulatory and incentive-based systems.

After much reflection on ways to promote corporate governance ratings as a market-based alternative to regulations, CMBT announced CGI at the end of 2004. Those listed companies that complied with the guidelines, as determined by independent rating agencies, would be included in the index. The idea of differentiating "better governed" companies by including them in a separately tracked index was not fully supported by ISE, but, the exchange followed the regulator's instructions.[16] ISE's March 2005 press release announced that the CGI would be launched as soon as five companies qualified. Qualification requires that a company receive a corporate governance score of six out of 10 by the rating agencies. Qualified companies are entitled to a 50-percent discount on listing fees, which in most cases covers the rating agency's costs.

15 The basis of opposition was that the draft mandated that all joint stock companies use IFRS and engage external audit. The Social Democrats argued that this would increase the dominance of Big Four audit firms and have a negative effect on the role of independent accountants, who are not familiar with IFRS. The government and the opposition were forced to reopen parliamentary discussions in March 2007 as a response to criticism from TUSIAD.

16 The reluctance is obvious when the Turkish and English Websites of ISE are compared: the English version does not mention CGI, whereas it is mentioned at the top of the Turkish Website.

REFLECTIONS ON THE DRIVERS OF REFORM: THE CORPORATE GOVERNANCE INDEX EXPERIENCE AND ITS OUTLOOK

The Novo Mercado was led by BOVESPA, a non-profit institution owned by brokerage firms. But, unlike the CMBT case, it was officially supported by other private actors and beneficiaries from its inception. The Brazilian Institute of Corporate Governance (IBGC) and the Private Sector Advisory Group (PSAG)[17] lent their credibility and prestige to the idea within the network of major global institutional investors. Another private actor was the National Association of Investment Banks (ANBID), which mandated that its members could only lead underwriting offerings for issuers that are registered, at a minimum, on Novo Mercado Level One. The support from the private sector was complemented by public entities, such as the Brazilian Development Bank (BNDES), the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários, CVM), and the agency responsible for oversight of Brazilian pension funds (SPC). The collaboration of the private and public sectors, under the leadership of private actors, was a distinct feature of the Novo Mercado.

The main drivers for Novo Mercado seem to be from within: demands from institutional shareholders and foreign investors to revitalize BOVESPA and stop the flight of Brazil's best companies to NYSE. In contrast, the drivers for reforms in Turkey were external (IMF stand-by financing and the EU), and the main actors were public institutions and the government. In Brazil, private actors were involved and provided thought leadership. Above all, Brazil had in place a policy framework that support corporate governance and guided policy reforms, another key factor in Novo Mercado's success.

17 The Private Sector Advisory Group of the IFC Global Corporate Governance Forum is comprised of more than 70 of the world's most prominent experts on corporate governance. Advisors volunteer their time and expertise to help implement better corporate governance practices in developing and transition countries. Members include corporate executives, board members, investors, lawyers, accountants, and financial journalists from developed and developing countries. Learn more: www.gcgf.org.

18 http://www.spk.gov.tr/ofd/KurumsalYonetim/index.html?tur=calistay

As recently as 2006, the general view of market participants, experts, and academics on the subject was expressed in a workshop organized by CMBT. Here is what they said[18]:

a) They do not expect CGI to meet its objectives, even if five companies eventually qualify.

b) The CGI and its selection criteria should be reviewed.

c) Although CMBT provided a weighting for each of the four headings of the guidelines, the respective weight of individual provisions under one heading is left to the rating companies to decide. This approach may introduce inconsistencies. The criteria for qualification and the weighting of each criterion should not be left to rating agencies but should be specified by CMBT.

d) The idea of a separate market based on additional listing requirements, such as the Novo Mercado with its corporate governance levels, should be reconsidered.

Moreover, since the launch of the guidelines and the index, foreign ownership in ISE-listed companies has significantly increased due to both direct investments and portfolio investments resulting from rising demand for Turkish assets. Turkey experienced a significant number of mergers and acquisitions where control has been transferred to foreign shareholders with premiums reaching 100 percent in some cases. High control premiums led to high prices for mandatory bids, which were eagerly accepted by minority shareholders. As a result, the percentage of traded shares was drastically reduced and the burden of complying with ISE regulations was hardly justified.

BOVESPA's Novo Mercado approach captures the key issues identified specifically by investors. Therefore, the better market performance of Novo Mercado companies comes as no surprise, although further research is needed to understand the long-term effects on returns.

The Novo Mercado case provides convincing evidence that consultation with major institutional investors on the requirements and soliciting their support for reform, including the CGI, is a very important step. It is also a step that may be more challenging since Turkey lacks the business and political traditions that Brazil had, which include experience in building consensus. Cultural differences, then, are among the most important determinants of success in ushering in market-led corporate governance reforms. After comparing the similarities and differences between Brazil and Turkey, the authors link Brazil's success to the influence of a broader range of investors (including pension funds and foreign investors) than is the case in Turkey. Those investors in Brazil participated in a policy-making process that drove corporate governance reforms, including the Novo Mercado.

Recommendations for Istanbul Stock Market's Corporate Governance Index

We recommend combining the ISE and Novo Mercado approaches. A company that receives a score of six or more out of 10 can be included in the index regardless of the specific guidelines that it meets or doesn't meet. In our view, inclusion should be subject to full compliance with relatively few key criteria (related with sine-qua-non issues such as shareholder rights and accountability of insiders). These criteria should be identified in consultation with international and local institutional shareholders. The Novo Mercado case provides convincing evidence that consultation with major institutional investors on the requirements and soliciting their support for the index may be very important. A corporate governance assessment report may be required to provide further insight into a company's level of compliance with more than 100 provisions of the guidelines.

Those companies that do not like the idea of exposing themselves to outside scrutiny by involving a CG rating agency may signal commitment to good governance by announcing their compliance.

We provide the following set of requirements to determine if companies qualify for the index:

a) Minimum free float of 25 percent at any one time

b) Minimum 500 shareholders at any one time

c) Disclosure of ultimate ownership at the level of real persons

d) Disclosure of ownership of "groups of shares" with board nomination rights

e) Requirement to disclose board nominations before the general assembly if there exist shareholder agreements on nomination rights

f) Filing of *all shareholder agreements* with ISE immediately after signing

g) No founder shares

h) A commitment to external audit of all transactions between related parties exceeding a predefined value

i) General assembly approval for mergers and major transactions, including sale of assets above a certain value

j) A maximum wedge (deviation of cash flow rights from control rights)

k) No non-voting shares

l) Disclosure of direct or indirect ownership interests exceeding five percent up to the ultimate level of real person shareholders

m) Disclosure of contracts with related parties—e.g., above one percent of company's net worth, based on a clear definition of related parties by the regulator

TO LEARN MORE ONLINE

Corporate Governance Codes and Principles – Turkey

http://www.ecgi.org/codes/code.php?code_id=117

Corporate Governance of Turkey at Sabanci University

http://cgft.sabanciuniv.edu/eng

CGFT is a reserach and advocacy center hosted by Sabanci Univesity Faculty of Management focused on empirical research.

Report on the Observance of Standards and Codes (ROSC). Corporate Governance Country Assessment for Turkey. April 2004. The World BankGroup.

http://www.worldbank.org/ifa/rosc_cg_turkey.html

This Corporate Governance Assessment was completed as part of the joint World Bank-IMF Reports on the Observance of Standards and Codes (ROSC). This report benchmarks the country's observance of corporate governance against the OECD Principles. CHECK.

Istanbul Stock Exchange

http://www.ise.org

Turkish Corporate Governance Association

www.cogat.org

In 2003, the Turkish Corporate Governance Association was established; its mission is to raise awareness by training the various corporate players on how to enable good corporate governance based on existing principles, with the main issues in the Turkish business environment being board effectiveness.

Turkish Securities Regulator

http://spk.gov.tr

Turkish Stock Market Investors Association (BORYAD)

http://www.boryad.org/English.htm

Established in April 2001, Turkish Stock Market Investors Association is the first and only civil organization that represents the rights of more than two million investors.

Oganization for Economic Co-operation and Development

http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html

Download a copy of the OECD Principles of Corporate Governance in Arabic, Azerbaijani, English, French, German, Italian, Japanese, Polish, Portuguese, Russian, Serbian, and Spanish.

Corporate Governance in Turkey: A Pilot Study

http://www.oecd.org/document/6/0,3343,en_2649_37439_37490374_1_1_1_37439,00.html

The 2006 report examines the extent to which the OECD Principles have been implemented in Turkey.

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