Corporate Governance in Turkey; Implications for investments and growth

Background Paper for Turkey's Investment Climate Assessment 2006

Melsa Ararat

Hakan Orbay

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I. Introduction; Corporate Governance and Growth

Corporate governance (CG) is related with the structures and processes for the direction and control of companies. Definitions vary but a key aspect of CG is ensuring the flow of external capital to firms. From the perspective of finance, "CG deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investments.[1]"

Country factors such as the quality of laws, the depth and liquidity of securities markets, the quality of banking system, the level of enforcement, disclosure infrastructure and culture play a determining role in setting the environment for corporate governance quality at the firm level. Lower the local standards, higher would be the costs of adopting better governance practices for individual firms. For example issuing IFRS based financial reports would be much costlier for a firm, if the local standards are inferior. Similarly, although the most important benefit from having good governance is that it facilitates access to capital markets, this would be worthless if the firm is located in a country with poor financial development.[2] On the other hand the potential for financial sector to maximize the opportunities for growth is dependent upon the way corporations are governed. CG and financial development are interrelated.

CG mechanisms in developing countries primarily depend on large block holders, bank monitoring (depending on health of banking system), reputation and self enforcement rather than market control and law enforcement. Concentrated ownership largely solves the free rider problems but it is associated with entrenchment of the owner/managers, higher risk exposure and liquidity constrains. At the aggregate level, these lead to poor development of capital markets and impediment of growth.

A less emphasized but equally important aspect of corporate governance is the effect of corporate governance on companies' operating performance. The relation between CG and organizational performance is of fundamental importance. In the Turkish context, this is closely linked to professionalization of family-run firms and separation of management and control roles. A strong CG system aligns managerial and shareholder/investor interests and incorporates checks and balances that lead to better decisions to maximize company value. Two interdependent institutional factors can determine how closely the shareholder/investor interests and managerial interest are aligned and how easily the shareholders can monitor the management; (i) ownership and control patterns and (ii) the corporate governance structure as defined by the legal system. As the protection offered to shareholders/investors improves, expropriation becomes more costly for controlling shareholders. This may increase the importance of cash flow benefits over the private benefits for the controlling shareholders and lead to professionalization of the firm and performance improvements.

CG affects growth through a number of channels. The obvious one is the increased access to finance as a result of increased investor confidence via capital markets, leading to larger investments and employment. The second one is increased valuation of firms based on lower cost of capital leading also to growth and employment. The third channel is better operational performance through better use of resources and better management.

[1] Shleifer and Vishny (1997)

[2] The same applies to supporting legal and regulatory improvements and complying with the existing laws and regulations.

Better operational performance is also associated with better relations with all stakeholders[3] contributing to the sustainability of businesses.

CG matters both for portfolio investors and direct equity investors since valuable growth opportunities that can not be financed with internal funds and debt can potentially be financed by capital markets. Better governed firms attract better employees. Furthermore, better governance standards encourage fair play, promoting competitiveness, innovation and productivity.

Empirical evidence shows that it is not the presence of laws but rather enforcement that helps explain the development of financial and securities markets. Regulatory enforcement plays a more vital role in emerging markets since market forces are weaker. Although empirical evidence for the relationship between observable CG characteristics and economic performance is not conclusive for developed countries due to the tightened legal and regulatory regime which followed corporate scandals, there is ample evidence for a positive and causal relationship between corporate governance quality and performance at firm level in developing countries[4]. Better governance is found to be positively and significantly related to firm valuation in Korea, Russia, Thailand and Indonesia. A recent study covering 51 largest and most liquid Turkish companies indicates that transparency of board structure and processes, as a proxy for better governance, is related to both better market and accounting performance[5].

This report aims to provide an assessment of Turkey's corporate governance regime and practices with a view to identify key issues and obstacles to investments and growth. We will focus on two aspects of CG framework in Turkey; (i) legal and regulatory protection offered to outside investors against the abuse and expropriation by the controlling shareholders, (ii) managerial practices and behavior as they relate to ownership structures. These two factors together determine how the companies are directed and controlled in Turkey.

II. Corporate Governance in Turkey, a summary

The governance of Turkish companies is characterized by highly concentrated ownership and insider-dominated boards. From 1986 when trading started at the Istanbul Stock Exchange, the market was characterized by opportunistic IPOs and a high occurrence of market abuses (especially market manipulation and insider trading). Related lending and transfer pricing were common practices and were unregulated. Government bonds and treasury bills absorbed most of the available private capital; companies lacked strategic direction, focused on day to day operations and delayed investments that were necessary to achieve competitiveness if the market were freer. This environment created a culture of risk averseness and shaped the nature of managerial practices - which were typified by highly informal systems and a distrust of formal mechanisms. Concentrated ownership continued to be the dominant form of corporate governance[6]. Against this background boards continued to be highly ineffective as a governance mechanism.

This grimy picture started to change from 2001 as the macroeconomic outlook improved. Firstly, the legal and regulatory framework was strengthened considerably – a process

[3] Claessens (2003)
[4] Black, Jang and Kim(2005), Brown and Caylor (2005), Gompers, Ishii and Metrick (2003)
[5] Aksu and Kosedag (2006)
[6] For a macroeconomic view on corporate governance see Ararat and Ugur (2003)

that still continues thanks to anchors such as IMF and EU. Secondly, enforcement has improved. Thirdly, increased interest from foreign portfolio investors and direct investors in Turkish companies has forced companies to put their house in order – a process which has proved to be much more difficult and protracted than changing the rules. [7]

Improvements to the legal and institutional framework for corporate governance were pioneered by the Capital Markets Board (CMB) in Turkey with upgrading of accounting, reporting and auditing standards in line with international standards, followed by issuance of Corporate Governance Guidelines (the Guidelines) in July 2003. As of 2004, listed companies are mandated to include a CG compliance statement in their annual reports. Moreover, IFRS became mandatory in 2005. These requirements improved the transparency of listed companies and shed light to governance issues in Turkey in general. At the same time, restructuring of the banking sector with a new legal and regulatory framework for financial institutions provided the stimulus for further improvements. Returning back to their core business of banking under much stronger local and international supervision, banks started to play a significant role in monitoring companies. Limitations imposed upon related lending on one hand and decreasing interest rates for government loans on the other forced the banks to look into the small to medium size enterprises (SMEs) as a new customer segment. Banks continue to act as change agents by educating SMEs on the importance of reliable financial information.[8] These reforms represent a spectacular progress in the Turkish corporate governance framework in a relatively short time.

Summary of Issues:

Against the above background with a positive trend for better standards, current CG issues in Turkey can be related to the following aspects of the Turkish CG regime;

- Concentrated ownership and economic power associated with complex and opaque control structures with still significant state stake in some industries,[9]
- Uncontested power of controlling shareholders due to low floatation rates, limited institutional shareholding and weak equity culture,
- Unclear separation of management and control roles, ineffective boards, weak firm level formal control systems
- Market abuse (market manipulation, insider trading) as a result of the above
- Weaknesses in enforcement[10]

Key issues underpinning the above aspects are:

- Ownership and control structures
    - Weak disclosure regulations on the transparency of ownership

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[7] For a discussion on the affect of macroeceonomic stability on corporate governance system and practices see Ugur and Ararat (2006)

[8] For example Akbank educated 5000 SME representatives on the implications of BASELII on qualification of companies for receiving credits.

[9] For a discussion on comparative transperancy of Turkish corporations see S&P-CGFT (S&P-CGFT 2004 and 2005)

[10] For sources of comparative data see Kaufmann, Kray and Mastruzzi (2003)

- Lack of central company registrar
- Weak risk management and internal audit practices
- Poor reporting on connected lending, transfer pricing and related party transactions, and on identity of insiders
- Weak contractual status of employees and professional managers
- No disclosure requirements on privately entered share purchase agreements or shareholder agreements

- Shareholders Rights
  - Inefficient judiciary (lack of private enforcement)
  - No role for shareholders in major asset transactions
  - Weaknesses in regulations related with preemptive rights and mandatory bidding
  - Legal barriers to shareholder activism
  - Wide use of privileged share classes and share groups
  - Lack of independent research
- Transparency
  - Poor accounting and reporting standards (except publicly owned companies and banks)
  - Weaknesses in financial reporting especially in relation to consolidation
  - Delays in disclosure of material events (which does not include consolidated entities)
  - Limited audit capacity
  - Lack of credible non-financial information disclosure

Recent and forthcoming improvements in the legal and regulatory framework have the potential to radically improve the quality of the CG regime in Turkey. These improvements will require different leadership skills and management capabilities than those prevalent during the pre-reform period. There is however a number of less obvious challenges stemming from Turkey's societal culture characterized by power distance and hierarchical control. Turkey's efforts to institutionalize democratic principles and encourage civic involvement needs to reflect on the relationship between powerful owners and other stakeholders. Concentrated ownership, which may have been a response to weak ownership rights, may become a disabling legacy.

III. Institutional Framework and Market Overview

a. Statues

La Porta et al (1998) show that French civil law countries are least protective of minority shareholders. Turkey is a country in the French tradition. One of the building blocks of

CG legislative framework, the Commercial Code (CC), was originally taken from French Commercial Code in 1850 and amended in 1926 and 1956 with provisions taken from German, Swiss and Italian law. The 1956 version, with its evidently eclectic nature, forms the basis of equity contract and provides the legal framework for incorporation, general assemblies, shareholder rights, definition of shares and bonds and their issuance[11]. The Capital Markets Law (CML) had provisions taken from the Anglo-Saxon (common law) legal system but still has its roots in civil law. It primarily provides the legislative framework for securities market activities and establishes the CMB. Separate laws regulate the banking and insurance sectors. A major issue of legislation is related with the ambiguities in law and inconsistencies between CC and CML.

The legal and regulatory framework governing Turkish firms comprise the following:

<u>Laws;</u>

- Commercial Code 6762 (1956),
- Capital Markets Law 2499 (1981) – major amendments by Law 3794 (1992) and Law 4487 (1999)
- Decree-law No.91 (1984) - regulates establishment and activities of the stock market
- Decree- No.32 (1989) – provides for equal treatment of foreign investors
- Banking Law 5411 (2005)
- Banks Act 4389 (1999)
- Competition Law 4054 (1994)
- Bankruptcy Law 2004 (1932)
- Code of Obligations 818 (1926)
- Tax Procedural Law (1950)
- Law of Independent Accountants and Sworn in Financial Advisors 3568 (1989)

<u>CG related regulations;</u>

- CMB's Regulations and Communiqués related with
    - Capital Market Instruments (Common Stocks, Bonds, Participative Dividend Shares, Profit and Loss Sharing Certificates, Bank Bills and Bank Guaranteed Bills, Commercial Papers, Gold, Silver and Platinum Bonds, Asset Backed Securities, Real Estate Certificates and Foreign Capital Markets Instruments)
    - Capital Market Institutions (Intermediaries, Investment Trusts, Venture Capital Investment Trusts, Real Estate Investment Trusts, Mutual Funds and Rating Agencies),
    - Exchanges (Stock Exchange, Precious Metal Exchanges, Derivative Exchanges)
    - Corporate Governance Principles
- BRRS's Regulations and Communiqués
    - Regulation on Accounting and Reporting

[11] Ararat and Ugur (2003)

- o Regulation on Procedures and Policies of Independent Audit
- o Regulation on Bank's Internal Control and Risk Management Systems

The backbone of the legal framework, the Commercial Code (CC), borrowed from French company law in the 19th century, is outdated. It has crucial weaknesses, and is also inconsistent with both the more recent and Anglo-Saxon influenced Capital Markets Law (CML) and the new Banking Law. The Code of Obligations and Bankruptcy Laws are also outdated and in need of alignment with the Draft CC.

Draft Laws and regulations awaiting approval;

- Draft Commercial Code
- Draft Law on Housing Finance-Mortgage System (CMB)
- Draft Capital Markets Law (CMB)
- Draft Regulation on Independent Audit Standards (CMB)
- Draft Financial Services Act (BRSA)
- Draft Banks Act (BRSA)

The Draft CC, which aims to align Turkish company law with the European Union directives and its CG Action Plan, is radical and comprehensive[12]. In general terms, the proposed amendments relating to joint stock companies are intended to: (a) eliminate a number of important differences in the regulation of closely held and publicly traded companies (especially with respect to financial reporting, transparency and the functions of boards and auditors); (b) provide more protection to minority shareholders and creditors, *e.g.* through new provisions relating to company groups; (c) bring Turkish company law into alignment with EU directives; and (d) facilitate the use of technology in company affairs (such as electronic shareholder meetings). Draft CML, which is currently in consultation, provides improvements to the enforcement framework for listed companies and introduces new instruments. The draft narrows the scope of CML's coverage by increasing the maximum number of shareholders which a company remains as privately owned from 250 to 500, provides for regulated share buybacks, squeeze-outs of minorities following tender offers and rights for shareholders who vote against mergers to demand that their shares be purchased at a fair price. It also brings the laws on market abuse into alignment with EU directives and strengthens the provisions related with the accountability of the CMB by introducing independent annual audit of the CMB. Finally the Draft Regulation on Independent Audit Standards brings important and significant improvements to the audit framework for listed companies in compliance with the EU Company Law 8th Directive. The Draft Financial Services Act and Draft Banks Act also include significant provisions related with the governance of the credit lending institutions.

Without the enactment of the draft laws and regulations listed above, the legal framework for corporate governance in Turkey will remain severely inadequate. [13] IIF's recent report[14] on CG in Turkey presents a detailed review of Turkish statues against widely accepted CG principles and best practices required by the investment community, to

[12] For a detailed discussion see Ugur and Ararat (2006)
[13] For a detailed discussion see Ararat and Ugur (2003) and EU's accession report, Nov.2005
[14] IIF(2005)

conclude that without the effective enforcement of CMB's CG Principles and enactment of Draft Commercial Code, Turkey falls behind the minimum standards.

An important anchor for Turkish CG framework is the EU directives and recommendations, of which most relevant are the following;

- Directive on Financial Conglomerates (2002/87/EC)
- Directive on Credit Institutions (2000/12/EC)
- Directive on Transparency Requirements (2004/109/EC)
- Recommendation on Directors Remuneration (2004/913/EC)
- Recommendation on Independent Directors (2005/162/EC)
- Draft Directive on Board Responsibility and Improvement of Financial Information (COM (2004) 725)
- EU Regulation 1606/2002/EC on IFRS (CMB's Communiqué XI-25 provides compliance)
- Directive on Prospectuses (2003/71/EC) and Insider Dealing (2003/6/EC)
- 4th Company Law Directive on Annual Accounts (78/660/EEC)
- 7th Company Law Directive on Consolidated Accounts (83/349/EEC)
- 8th Company Law Directive on Independent Audit (CMB Communiqué X-22 partially meets the criteria)

Company law *Acquis*[15] includes rules on the company law, accounting and auditing. In the area of financial reporting, the *acquis* specifies rules for the presentation of annual and consolidated accounts, including simplified rules for SMEs. The application of IAS is mandatory for some public interest entities. In addition, *acquis s*pecifies rules for the approval, professional integrity and independence of statutory audits. The latest accession report on Turkey dated November 2005 notes limited progress in the field of company law, in adoption of IFRS and IAS and in auditing, specifically referring to delays in establishing Accounting Standards Board (ASB) *as a separate body* with an improved regulatory framework. It suggests that the regulatory framework needs to be extensively redefined as regards the scope and the type of responsibilities of independent auditors. Lack of central company register and unavailability of financial information electronically are other shortcomings noted by the report.

Draft CC would cover most of the requirements of the 4th and 7th Directives. Draft Regulation on Audit Standards is expected to meet the requirements of the 8th Directive for listed companies. Recommendations on Directors Remuneration and Independent Directors are somewhat addressed by the CMB's CG Principles but compliance is only voluntary. Directive on Transparency is partially met with the current CML and the Guidelines. Draft Banks (Credit Providers) Act and Financial Services (Banking) Act cover EU Directives 2000/12/EC (credit institutions) and 2002/87/EC (financial conglomerates). They introduce significant improvements to the ownership, control and governance of financial institutions, however they have been heavily criticized by various constituencies and they are not expected to be enacted soon.

[15] The acquis includes all primary legislation (treaties), secondary legislation (regulations, Directives, Decisions, Recommendations, etc.) and case law.

The draft Banking Act sets the ground for dissolving the financial and industrial arms of family owned conglomerates by ensuing reduction in connected lending and limiting shareholding of banks in non-financial institution to a maximum of 15% of its own funds from the current level of 20% . The draft gives ample powers to Banking Regulatory and Supervisory Agency and holds the board and senior managers liable, jointly and severally, for the repayment of credits extended in violation of the act. In addition to general technical requirements for prudent banking (in areas such as accounting, risk management, internal control, bad loan provisions, capital adequacy, elimination of full state guarantee on deposits, etc.) the draft Banking Law provides for alignment with international best practices and sets strict criteria concerning the personal integrity of general managers, assistant general manages and board members. It authorises BRSA to issue mandatory Corporate Governance Rules which includes a strong component of independence in the Board assured by statutory approval of independent member nominations.

CMB has initiated a twinning project in December 2005 with the objective of completing the alignment of the capital markets legislation and its proper implementation in accordance with the EU Acquis Communautaire. A twinning contract has been signed with the German Federal Ministry of Finance. The project has started in December 2005 and is expected to be completed in November 2007. The project is a demonstration of CMB's commitment to harmonize the legal and regulatory framework with that of EU at the same pace with member states. German law recognizes group structures; we believe this will also contribute to effective implementation of EU directives within the Turkish context where business groups are dominant.

In the remaining parts of this report we will indicate the deficiencies of the legal system in effect and comment on where the drafts will provide an adequate improvement.

b. Institutions

Key institutions with statutory powers and/or responsibilities related with corporate governance are the following:

- Banking Regulations and Supervisory Agency (BRSA), established in 2001(?)
- Capital Markets Board (CMB), established in 1982
- Istanbul Stock Exchange (ISE), established in 1985
- Competition Authority (CA), established in 1997
- Accounting Standards Board (TMSK), established in 1999
- Chambers of Independent Accountants and Certified Public Accountants, and Sworn-in Certified Public Accountants (together forms the union; TURMOB), established in 1989[16]

The BRSA is the principle competent authority for banks whereas the general directorate for insurance of the Undersecretariat of Treasury is the principle competent authority for insurance companies. The BRSA establishes the financial reporting standards of the companies they regulate, monitor the compliance with the standards, set audit standards for external audit, authorize and monitor the conduct of external audits and set sector

[16] www.turmob.org.tr, TURMOB has 60679 registered accountants and 3474 financial advisors

specific prudentially oriented standards. Publicly owned banks are subject to CML related with their securities market activities and hence they are also required to issue CG compliance report.

The CMB develops, regulates and supervises Turkey's securities markets under the authority of a State Ministry in charge. It drafts statutory laws to be submitted to parliament for approval and issues communiqués (rules) and regulations. These rules are published in the official gazette after receiving clearance from the related Ministry. The CMB develops corporate governance standards for publicly held companies and determines the ISE's listing standards. It has extensive supervisory powers. It is authorized to suspend trading, stop public offerings, change time limits for subscription periods, as for special reports and disclosure, require purchasing of minority shares at market prices, ask for remedial measures if company's financial health is in trouble ask for liquidation of financial intermediaries and take the cases of violation to the public prosecutors. CMB approval is required for a wide range of fundamental changes. CMB staff monitor publicly held companies' disclosures and can attend shareholder meetings as observers. The CMB sets financial reporting and independent auditing standards for most publicly held companies and capital markets institutions (except banks and insurance companies) and licenses and supervises the auditors of most publicly held companies, market intermediaries and rating agencies. It has wide investigation powers. Its Executive Board can also exercise certain enforcement powers, such as: (a) order or cause the disclosure of information; (b) ban certain persons from participating in organized capital markets if the Executive Board finds that they have committed certain financial crimes; (c) refer suspected financial crimes such as insider dealing to the Public Prosecutor; and (e) impose administrative pecuniary penalties for certain breaches of capital markets laws. The members of the board are appointed by the Cabinet for a 6 years term.

ISE's status is rather complicated; it is financially independent but closely supervised by the CMB. It is governed by an Executive Council elected by the General Assembly composed of its members for a term of four year whereas the chairman is appointed by the government for a term of five years. Its revenues are generated from fees charged on transactions, listing procedures and miscellaneous services. The profits of the ISE are retained to meet expenses and to undertake investments, and are not distributed to any third parties. The ISE has its own budget, but its costs and expenses have been strictly monitored by the ministry through the CMB. For example limits are imposed upon the salaries and expenses. ISE members are incorporated banks and brokerage houses authorized by the CMB.

A key issue with the enforcement of laws and regulations in force is the inconsistencies and lack of coordination in between, and clarity about, the authorities of CMB, BRSA, and Ministries of Finance (oversees CML) and Trade and Industry (oversees CC). The draft CC resolves some of problems by establishing the legal authority of the CMB on corporate governance issues and requires all other regulatory agencies to consult and seek approval for any sector specific provisions.

Additionally, there are voluntary professional associations with no statutory rights. Their legitimacy depends on their international affiliations which are no longer subject to government permission thanks to the new Associations Act. The most relevant professional organizations are as follows:

- Institute of Internal Audit (TIDE), established in 1994.[17]
  TIDE is granted the National Institute Status by Institute of Internal Auditors (IIA) and is a member of European Confederation of Institute of Internal Auditors (ECIIA), has a regular publication of high quality content and is authorized to conduct Certified Internal Auditor (CIA) and CCSA, CFSA and CGAP exams since 2000. TIDE currently has 642 members. So far, 122 professionals have been awarded CIA status.
- Risk Management Professionals Association (RYD), established in 2002[18]
  RYD is young and has only 162 members, mostly from banks. It is affiliated with Global Association of Risk Professionals (GARP).
- Turkish Institutional Investment Managers' Association (KYD), established in 1999[19]
- Turkish Shareholders Association (BORYAD)[20]
  BORYAD brings together the individual investors and has recently become a member of Euroshareholders.

Other institutions that play a role as opinion leaders are

- Corporate Governance Association (TKYD) which brings together executives interested in corporate governance issues has approximately 246 members[21]
- TUSIAD's corporate governance task force, consisting of voluntary individuals from member companies
- Sabanci University's corporate governance research and advocacy center; Corporate Governance Forum of Turkey (CGFT)[22]

Currently there are two corporate governance rating agencies registered with the CMB; Institutional Shareholder Services (ISS) and Core Ratings and one boutique consulting firm dedicated to offer corporate governance consulting services. The rating agencies offer corporate governance rating services in Turkey by bringing in analysts from their European offices subject to CMB's regulatory supervision. The only locally established credit rating agency is Fitch Ratings. So far only two companies have disclosed a corporate governance rating score.

c. Enforcement regime

In the absence of class actions and derivative actions, and insufficient use judicial system by private persons in general, the role CMB plays becomes very important Throughout the 1990s, there were severe operational problems with the legal process and law enforcement in Turkey. First of all, ministers and members of parliament enjoyed extensive immunity against corrupt practices, which included permissive supervision, lenient law enforcement and distribution of rents in return for political support. Secondly, the process was complicated, slow and costly; or it was unpredictable due to heavy reliance on decrees. Thirdly, the general inefficiency of the legal process and the weaknesses in law enforcement compromised the institutions that were introduced to

[17] www.tide.org.tr
[18] www.ryd.org.tr
[19] www.kyd.org.tr
[20] www.boryad.org
[21] www.tkyd.org
[22] www.cgft.sabanciuniv.edu

supervise listed corporations. After 2001, a number of instruments were introduced to strengthen the enforcement such as the New Civil Code and Civil Procedure Code (2002), New Panel Code and Panel Procedure Code (2002) to improve the judicial independence, law on Justice Academy (2003) to improve court efficiency.

Since 2000, the CMB has filed complaints to the office of public prosecutors for around 100 violations of Capital Market Law (CML) every year. As shown in Table 1, only one case in each year has reached decree absolute, with the rest resulting in dismissals and adjournments. The average time between the CMB's appeal and the first verdict (excluding decisions on adjournment and dismissal) was more than 12 months. The public prosecutor had not reacted to files concerning 26 cases in 2001 and half of the cases in 2002. The result is that only 1 % of all complaints ended up with any punishment.

Table 1: Cases commenced after application of the CMB to the public prosecutor

		Distribution by topic			Judging Stage		
Year	**Number of Applications**	**Insider Trading**	**Manipulation**	**Others**	**Investigation**	**Pending**	**Adjudicated***
2002	124	1	78	45	41	40	43
2003	158	1	93	64	67	84	7
2004	124	2	77	45	78	46	0

Source: CMB Annual Report, page 75

** Out of 50 cases in 2002-2003, only one case resulted in condemnation (2%), 39 was suspended and 4 was dismissed*

In Turkey, violation of CML is not sufficient for prosecution, which takes place only after application by the CMB. Therefore, it is important that the regulator has the means and capacity for market surveillance. The CMB has invested considerably in renewing its information system and technical infrastructure in recent years. The new system which provides for a real time monitoring of the market, has capabilities to give early warnings about abnormal security trades. It also incorporates Public Key Infrastructure technology which allows usage of digital certificates and digital signatures for timely electronic disclosure of financial and non-financial information via a secure computer network. By the end of the project, the Capital Market Board will have established a secure communication and data transfer infrastructure between itself and all relevant companies, intermediaries and other institutions The CMB took further measures to encourage investors play a monitoring role by establishing a task force within CMB with the mandate to respond and act upon investors' request for information. In 2003 and 2004, 5859 request for information was submitted to the CMB and 97.20% of these were concluded.

Private enforcement is considered to be the most powerful enforcement, but rarely used by minority shareholders in Turkey. Shareholder activism is minimal and associated with international institutional investors. While the percentage of international institutional investors' shares in publicly traded equities increased from around 40% to around 80% in the recent years, average value of shares held in a single company by an institutional shareholder is small to justify any cost of monitoring. Individual investors (day traders) hold majority of the locally held shares. Anecdotal evidence suggest that hedge funds are

the most active shareholders, requesting information, filing complaints with the CMB and so on. Although pension funds are rapidly growing, they are still fairly small and their portfolio choices are limited due to the shallow nature of the market. Some market participants argue that the portfolio choices are biased as most funds of the funds are managed by the investment management companies associated with business groups and cross investments are common between companies that are in friendly terms. CMB reports that the only significant use of legal system with respect to shareholders rights were related with companies which failed to implement the mandatory cumulative voting directive for unlisted firms with more than 500 shareholders. In a survey conducted in 2003 among 1292 investors to identify the training and education needs, 60% of the sample stated that their knowledge about shareholders rights were less than satisfactory; 71% never read the prospectuses whereas only 38% regularly reads the disclosures of material events. 28% of the sample never read the financial statements. 49% of the investors in the sample stated that they don't need to be educated about their rights since there is no enforcement.[23]

Modern capital markets of Turkey have been operational for only two decades now, although history of equity trading goes back to the turn of the century. Formation of capital markets was initiated by enactment of Capital Markets Law in 1981, and establishment of Capital Markets Board a year later. Following inauguration of Istanbul Stock Exchange (ISE) in 1985, equity trading commenced in 1986. Figure 1 shows the development of ISE equity market in terms of trading volume and market cap index.

FIGURE 1 here

Prior to 1990, trading was insignificant. Since 1990, ISE has shown a strong overall growth, but also very high volatility reflecting the period of economic turbulence. In the last 15 years, average annual return was 30% in US$, with a standard deviation of 60%. Volatility, however, displays a marked decreasing trend; while annual volatility was around 90% in the early years, it has declined to around 40% in recent years.[24]

Similar to other developing countries, ISE is an underdeveloped equity market. As of May 2006, market capitalization has reached $143 billion. This represents 30-35% of GDP, well below OECD average of 135%. Equity shares of 272 companies are traded, together with shares of 10 real-estate investment funds and 26 mutual funds. The list of public companies includes only one-fifth of the largest 500 companies. Foreign share in free float was around 60% by the end of 2005. There are roughly 1.2-1.3 million retail investors. 290 mutual funds have assets of USD 21.9 billion, 96 pension funds have assets of USD 836 million and 38 investment trusts have assets of USD 887 million. At the end of 2005, market capitalization of listed banks represented approximately 29% of the total market capitalization of the ISE and 23% of the total traded value.

In addition to equity market, ISE is also the secondary market for government and corporate bonds, though there have been no corporate bond issues so far.

A separate exchange for derivative securities, Turkish Derivatives Exchange (TurkDEX), was established in 2004. Currently, only the futures markets, including contracts on currency, stock market, government bonds and some commodities, are active.

[23] Survey on the financial literacy of investors, TUSSIDE
[24] Standard deviation figures are estimated from monthly returns on ISE100 index.

Settlement service to both ISE and TurkDEX is provided by Takasbank, which is also the custodian bank for all traded securities. According to the CMB regulations, no institution other than Takasbank is permitted to store physical certificates of securities in Turkey. Corporate actions, such as dividend payments and rights issues, are also facilitated through Takasbank.

As of May 2006, foreign investors held 65% of the equity value in ISE. Data is not available on the type of investors; nevertheless, it reasonable to assume that majority of foreign investors are institutional investors. On the domestic side, institutional investors have been weak, but gaining a higher share. Domestic institutional investors are mainly mutual funds formed by financial intermediaries; however, recently established pension funds are the fastest growing group of the institutional investors. Following the first establishment of pension funds in October 2003, total investment grew to 1.2 billion YTL (approximately €750 million) as of December 2005.

FIGURE 2 here

Individual pension system has highly been stimulated by tax incentives based on EET type regime where premiums are deducted, the fund itself is not taxed and withdrawals are taxed within certain limits. There are also other tax incentives such as exemption of stamp duties, etc. that reduce the costs. The pension system is regulated by Undersecretary of Treasury and Capital Markets Board of Turkey. The system is well designed as regards to the custody, disclosure, portfolio management, monitoring issues. The private pension system of Turkey is still in its infant stage. Additionally, the Pension Fund By-Law states that pension funds shall not pursue the aim of participating in the management of any of the company whose shares they have bought and shall not be represented in the management of such companies. The legal structure of the fund is defined as an asset established for investments to be made with contributions collected by the company pursuant to and under pension contracts and administered within the individual pension accounts on behalf of the participants, in accordance with principles of risk diversification and fiduciary ownership. Fund does not have a legal entity.

IV. State of business organizations

Literature on Turkish business organizations is almost entirely based on companies listed at ISE, as reliable data is not available for the corporate sector at large. A study by Boston Consulting Group (BCG)[25] reports that there are around 35,000 joint stock companies in Turkey, making up 2% of all business entities. The figures vary since there is no central registry of companies in Turkey. The number of companies subject to CML (with more than 250 shareholders) is 637. In Turkey, joint stock is the only legal form for which a board is mandated; hence any corporate governance discussion will be limited to this form of business organization.

The corporations are generally categorized as small to medium size. BCG study also indicates that the number of corporations employing more than 250 workers is less than 2,000 – or approximately 5% of all corporations. Another 10% of these companies employ 100 to 250 workers.

[25] Boston Consulting Group (2005), report published on Corporate Governance Association's web site.

A good discussion of the business environment and post-crisis dynamics can be found in Lieberman and Yildirim[26].

a. Ownership and control structures

Ownership structures of Turkish companies can be characterized as highly concentrated. Typically, a majority of shares are owned by a controlling block, which is owned by members of a family in most cases. Even for public companies, the fraction of floated shares is quite low. Figure 3 shows distribution of free float ratio for the 272 corporations traded on ISE. In this group, average flotation ratio is 35.7%. Weighted by market capitalization, this ratio drops to 30.5%, indicating that firms with higher market capitalization have somewhat lower flotation ratios. The larger holdings are somewhat smaller and have more concentrated family ownership. Internationalization mostly takes the form of joint ventures or strategic partnerships with multinational firms.

FIGURE 3 here

In the initial public offering, the percentage of shares offered to the public can not be less than a specified percentage (25%, 15% and 5%) depending on the amount of capital of the company. 25% flotation is required for companies with capital more than 10 million YTL (app. €5 million), however there are companies with only 1% of the shares traded. There is no minimum offering rate for secondary offerings or minimum floatation rate after the initial public offering. Korea is an interesting example about the regulatory options that can be utilized in increasing the flotation rates.

Special attention should be paid to two types of organization, Business Groups and State-Owned Enterprises, as largest companies belong to one of these categories with few exceptions.

Business groups

Business Groups in Turkey are similar in character to those in other emerging countries, such as Korea, Mexico or India.[27] Business Groups emerged through diversifying investments of individuals and families leading to subsequent family control. There are only two major groups that are not controlled by families: Is Bank and OYAK. Is Bank was founded by Ataturk in the early years of the republic and bequeathed to the political party (CHP) during the single party regime. CHP still owns part of Is Bank together with the pension fund of the bank employees. OYAK is a unique organization, established through a special law, which functions as the pension fund of military personnel.

Except Is Bank and OYAK, these groups are organized around holding companies. Large groups have several subsidiaries listed, while central holding company may not be listed. Group affiliated companies dominate ISE. 13 holding companies and 8 affiliated banks account for 40% of the total market value of ISE.

Groups generally operate in diverse business lines, and intend to remain as diversified conglomerates.[28] Recently, several groups extended their operations overseas. Most groups have affiliated banks, and other financial subsidiaries. Group banks served to finance groups' activities, and tied lending was significant until recent regulations.

[26] Lieberman and Yildirim, section III.
[27] Lieberman and Yildirim, see VI.5
[28] Lieberman and Yildirim, see Box 4, Large Group Characteristics

Currently, tied lending does not seem to be a source of concern. In fact, recently many groups sold, entirely or partially, their banks to foreign groups as in-house financing lost its appeal.

Business groups are likely to be very important for growth of Turkish economy in the near term, due to the fact that they represent a significant fraction of equity capital available for investment. An important concern is that, in general, groups shy from technology related investments and are weak in research and development. Technology needs have been generally addressed through licensing and local joint-ventures with multi-nationals.

State-Owned Enterprises (SOE)

At the time Turkey was founded in 1923, virtually no industrial production existed in the country. During these early years, with little private capital and entrepreneurial know-how, the only means of establishing an industrial base was through investments by state. Consequently, SOEs were established in almost every basic industry. By 1985, when the first privatization program was initiated, most industries were dominated by SOEs (see LY). With the initial privatization program, many SOEs were converted into joint stock companies. However, privatization did not proceed smoothly. Despite the faster pace in recent years, there are still a large number of SOEs on the auction block.

For detailed discussion of SOEs and privatization program, we refer the interested reader to Lieberman and Yildirim.

Listed Companies[29]

In a study of listed companies, Yurtoglu[30] reports that families control 80% of public companies with an average voting block of 67%. In half of these companies, majority owner is a holding company controlled by the family. For the remaining 20% of the companies, the majority block is again 67% on average, held by state or institutions without family control.

Complex pyramidal structures are frequent, although there is a trend towards simplification of these pyramids. Through these structures, families maintain control with a much higher fraction of voting rights than cash-flow rights. For the family controlled companies, families claim, on average, 51% of cash flow rights compared to 67% of voting rights. For the median company, the ratio of voting rights to cash flow rights is 1.12, though the mean is much higher (5.3).

Despite concentrated ownership, there is a wide spread use of multiple class shares. Company articles of association may assign various types of privileges to different classes. According to CMB survey in 2004, %42 of public companies have share classes with a privilege of nominating board members, which is the most commonly used privilege. Other observed privileges are voting rights (21%) and nomination of statutory auditors (18%). As an example, Table 2 displays share classes in Adana Çimento, a cement company. Adana is a rare case where shares in all three classes are traded in ISE. Typically, shares in privileged classes are not floated.

[29] Adopted from Isik and Orbay (2005).
[30] Yurtoglu (2000)

Table 2. Share classes and privileges in Adana Cement

Share Class	Equity Capital Ratio	Cash Flow Rights	Voting Rights	Other Privileges
A	26%	54%	41%	- Two votes per share - Nominates 4 of 7 board members - Nominates 2 of 3 audit committee members
B	25%	36%	20%	- Nominates 1 of 7 board members
C	49%	10%	39%	- Nominates 2 of 7 board members

b. Financing Patterns and Equity Financing

A survey compiled by Central Bank of Turkey collected financial data from 6,667 companies of various forms and sizes from 2002 to 2004. The following key indicators in Table 3 are calculated from aggregates of all companies. Of these companies 442 (6.6%) employed more than 500 workers, but represent 50% of total sales and 52% of total assets. Therefore, the results are biased towards ratios of these large firms.

Table 3: Key indicators[31] from aggregate financial statements of surveyed companies.

	2002	2003	2004
Financial Leverage	44%	37%	26%
Debt/Assets	28%	24%	18%
Times Interest Earned	1.83	3.26	3.47
Trade Payables (% of total assets)	16%	15%	13%
Return on Equity	9%	11%	8%
Net Profit Margin	7%	6%	5%
Sales Growth		30%	28%
Net Income Growth		86%	26%

Source: Compiled from reports published at the web site of Central Bank of Turkey.

Other than equity, there are essentially two forms of financing available for companies: Bank debt and trade credit. Bank debt is typically short-term or subject to calling from the bank. Prior to recent years, long-term debt in the form of corporate bonds could not be considered due to very high real interest rates. Despite these limitations, debt constitutes 18% of the balance sheet. Furthermore, it is evident that trade credit is a significant form

[31] Financial leverage is the ratio of interest-bearing debt to sum of interest-bearing debt and equity, Debt/Assets is interest-bearing debt over total assets, and times interest earned is EBIT divided interest payments.

of financing for all firms. We suspect that trade credit dependence is more emphasized for small firms. It is also interesting to note that the corporate sector was highly leveraged and quite risky following the 2001 crisis. Over two years, leverage significantly declined and times interest earned (TIE) improved.

World Business Environment Survey (WBES) 2000, published by IFC, reports that 47% of surveyed Turkish companies use internal funds to finance investments, whereas only 8% use new equity capital from sale of stock. An interesting finding is that public offering of shares is observed more in medium sized companies (12.5%) than large companies (5.9%) by a significant margin. This is an interesting finding, indicating larger companies may be more concerned about dilution of ownership than financing growth through equity issues. The same is also observed in free-float ratios, i.e., larger firms on average floated a smaller fraction of shares which may be related with the lower minimum float rate set by the CMB for larger companies.

Figure 4 shows the number of IPOs at ISE and total value of issued equity (including seasoned issues) over the years, together with average value of ISE100 index. Overall, the pattern clearly identifies timing as an important criterion for equity issue decision. Total equity issued follows the ISE index closely.[32]

FIGURE 4 here

Isık and Orbay (2005) present evidence that ISE has not been a significant source of equity capital. To this end, they compute net equity flows to corporations listed in ISE by deducting cash dividends paid from total funds raised through IPOs, seasoned offerings and rights issues. Figure 5 depicts net equity flows over the years. As shown, net equity flow to companies from capital markets is disappointingly low. Even including the record 2000 year, net equity flow to all ISE companies in the last 5 years was $677 million, including equity raised from privately held (non-floating) shares. Year 2004 is an interesting point. In general companies had record profits in 2004, and paid out more than twice the dividends paid in 2003. Yet, average payout ratio (excluding corporations showing a loss) was 10% compared to 20% in 2003.

FIGURE 6 here

V. Governance pillars

a. *Shareholders Rights*

Legal Framework

The fundamental rights of shareholders are based on four principles in Turkish CC. The first and the key aspect of the Turkish CC is the primacy of the company (the interests of the company comes before the interests of the shareholders). The law was enacted when state owned organizations were dominant in the economy with an understanding that joint stock companies are legal persons with an economic purpose. The joint stock company

[32] Year 1999 appears as an anomaly, but in fact it is not. Index jumped up 130% in the last two months of 1999, starting an IPO frenzy which actually materialized in 2000.

exercises her civil rights through her organs, namely the general assembly, the board, whose members must be shareholders, and the (statutory) audit committee[33]. With the direct representation of the shareholders in the board, the primacy of the company provides a solid basis for resolving conflicts of interests between controlling shareholders, (who tend to sit in the board), and the minorities. The primacy of company's interest is so fundamental that the directors may be liable for their actions even when they simply implement the decisions of the general assembly that are not serving the interests of the company. The other three principles that the CC is based are; equality (in treatment of the shareholders), diligence and care (in implementing the decisions made at the general assembly), and the duty of loyalty (of the company) to the shareholders and other stakeholders (directors can not trade with the company). On the other hand, CMB's CG Guidelines acknowledge the primacy of the shareholders.

Driven from the four principles, fundamental rights of the shareholders are the following; the right to receive dividends, the right to acquire information , the right to participate in general assemblies, the right to vote and challenge resolutions at the general assemblies, the right to appoint and dismiss the board at the general assembly, the right to have the company audited (through application to the statutory auditors), the right to file complaints and take civil action against directors who failed to duly perform their duties under certain conditions, and the right to participate in capital increases. General Assembly is the highest organ of the company and it is the primary vehicle for exercising shareholders rights. General assembly can not delegate the rights of the shareholders to decide on dividends (the law acknowledges profit as the ultimate purpose of the shareholders). The right to acquire information (limited to the right to review the financial reports and ask questions), the right to appoint and dismiss the directors and the right to participate and vote can not be abolished. Each share must have one vote, but multiple voting rights and non-voting shares are allowed if included in the articles[34]. Any changes in the articles must be voted with one share one vote principle regardless of the voting privileges[35]. Shareholders can not vote on matters related with them personally or their first degree relatives. Shares may have privileges related with the allocation of profit. In fact most companies have founder shares which entitle the founders a certain percentage of net profit similar to an ongoing founders fee. Usufruct shares (or dividend certificates), which are not a part of the capital, entitle the founders with additional cash flow rights.

Under law, the right to nominate board members can be allocated to a group of shares. This concept is different than privileged shares, as the privilege is not connected to a "class" of share but a "group" of "ordinary shares". In most cases when the shareholders sell the shares designated under a group with nomination rights, the privilege is disconnected from the share. CML also allows non-voting privileged shares but they are not common.

Joint stock companies with more than 250 shareholders are considered publicly owned and they are subject to CML[36]. CML further provides that shareholders have the right to

[33] Although joint stock companies are recognized as legal persons under law, the criminal liability is personal under the Turkish Criminal Code (2004). Therefore no penal sanctions are allowed to be implemented on legal entities; however security measures are allowed such as cancellation of permissions and confiscation of the assets.

[34] The Draft CC restricts the multiple for voting rights by 15

[35] The procedure for amending the Articles is inefficient. It involves 7 steps; board decision, ISE Disclosure, CMB application and approval, ministry application and approval, AGM approval, ISE disclosure, Trade Registry

[36] In the Draft CML, this number is increased to 500

acquire information through disclosure of material events, the right to go to courts to abolish decisions of the board under certain conditions, the right to vote through proxy, and the right to cumulative voting if the articles permit.

Minority rights start at 10% in CC and 5% in CML[37]. These rights include the right to postpone the discussions on financial reports for a month and the right to request special auditor to investigate alleged abuses. If this does not happen, then they are entitled to request the courts to appoint an auditor. If alleged abuses were to be found unsubstantiated, the minority shareholders are liable for damages caused to the company if they are proven to have acted in bad faith. Minority shareholders can call general assembly and add items to the agenda, veto the dismissal of the board, and have the right to take the directors to court.

Preemptive rights can be restricted by general assembly under CC and by the boards in public companies if they adopt the "registered capital system" and articles allow for it. According to the CML, restrictions of preemptive rights can not violate the principle of equality between the shareholders; therefore restrictions of preemptive rights are common in issuing new shares for public offerings. Merger contracts are subject to shareholder approval but major asset transactions are not according to CC or CML. Tender offers are mandated at acquisition of 25%, 50% and at every additional 10% of shares within a 12 month period. Privatization of state owned shares of listed companies is usually exempted. CMB may grant exemptions based on criteria defined in the regulations. It has become a routine practice to request exemption; more than 50 requests were made to the CMB in the past 3 years. Furthermore, since the privately entered agreements between controlling shareholders which may include non-pecuniary benefits are not disclosed and there is no disclosure requirement on the acquirer to share their insight of the acquired firm at the time of mandatory call, it is doubtful whether the transaction price reflects the maximum achievable transaction price. The sanctions/penalties are not deterrent and 15 day offer period is not sufficient.

AGMs must be convened by the Board within 3 months after the end of the accounting period, but in practice this is extended for another 1-2 months due to the time required for external audit. The Board proposes a dividend policy at the assembly. Every shareholder has the right to review the documents at the company headquarters at least 15 days before the assembly. For registered shares the documents are posted to shareholders. There is no requirement to disclose the documents or send them to the shareholders. CMB Guidelines require a 3 week period and that the notice should be given through both mail and electronic means and details the documents that should be included with the notice. Shareholders may vote by appointing a representative through a power of attorney (the proxy must be notarized).[38] Under the CC, there is a requirement of 1/3 quorum for adjourned meeting to amend articles there is no requirement for a quorum for adjourned meetings for public companies. AGMs are considered as a legal formality in Turkey. Holders of bearer shares and their proxies are required to receive admission cards or deposit certificates but this is not necessary for registered shares as the records of the central registry have primacy over companies' share registrar

[37] Guidelines recommend that the companies should target lower figures.

[38] International institutional shareholders usually participate in the assemblies through their custodians and the same few names appear in all attendance charts. General practice is to vote "against" unless required for quorum.

Shareholders can file complaints with CMB, ISE or the relevant ministries, shareholders who were present but had voted against a resolution or were deprived of voting rights, can request nullification of the resolution from the courts if decision was against the law, articles or good faith according to Articles 381 of the CC Boards can also appeal to the courts for nullification of the AGM decisions.

Failures to provide information can be filed with the statutory auditors. Class actions or derivative actions are not recognized by law but if there is more than one appeal requesting nullification of AGM decisions, these cases are combined.

Insider trading, the dissemination of misleading or false information and manipulative practices are criminal offences punishable by fines and imprisonment up to 5 years. CMB is responsible for surveillance and investigation and file with public prosecutors in case of suspect. There is no definition of "related part" in law, accept for financial reporting purposes under IFRS.

The rights of the stakeholders are not cited in CML or CC, however the CMB Guidelines has a separate section on stakeholders. Listed companies are required to disclose their policies related with the treatment of the primary stakeholders such as creditors, customers, employees end the society at large. Employee stock option or ownership plans are not provided for under Turkish law.

CMB Guidelines have comprehensive provisions by requiring that the provisions restricting proxy voting, share transfers should not be included in a company's articles. It calls for one share one vote and state that voting privileges should be avoided. It recommends that cumulative voting should be included in the articles, a provision that is not yet accepted by any company. The Guidelines require that major asset transactions should require shareholder approval.

The CMB announces mandatory dividend rates every year.

The Draft CC introduces substantial and radical improvements to shareholders rights as summarized in Table 4 below.

Table 4 - Articles related with minority shareholders rights in the Draft Turkish Company Law

Article	Rights subject to private litigation
141	Right to exit in mergers
200	Right to exit in case of abuse of dominant position by the controlling shareholder
438	Right to demand special audit
466	Right to participate in conditional issues of shares
466	Right to demand equal treatment
193	Right to demand nullification of major decisions from the courts
194	Right to hold the management liable for the consequences of major decisions
202	Right to seek remedy in case of abuse of power by the controlling shareholder
399	Right to request change of auditor
447	Right to request the nullification of AGM decisions
428, 429	Right to have cumulative voting rights and cumulative representation
428, 429	Obligation for the institutional representative to receive authorization before the AGM
200, 437	Right to request information and investigation
479	Limitation on voting privileges
198, 150	Disclosure obligations for exceeding threshold values in share acquisitions
1502, 1505	Right to vote electronically and right to receive information electronically

It aligns the company law with EU's Transparency Directive by introducing mandatory bid provisions, squeeze in and squeeze out provisions. It focuses on making it easy for the shareholders to exercise their rights and increases the efficiency of shareholder rights significantly. For example it allows the general assemblies to be recorded and broadcasted, and requires all join stock companies to allow electronic voting. It classifies the auditors into 3 groups; year end auditor, transaction auditor (mergers, capital increase, incorporation, IPO etc) and special auditor in case of alleged abuse.[39] One important contribution of the Draft is related with the representation of groups in cumulative voting based on a common attribute such as the distributors of an automotive company. Another creative provision is the concept of institutional representative concept which allows pooling of individual shareholders to exercise voting rights collectively.

Practice

A joint survey conducted by the World Bank and Lex Mundi[40] places Turkey 73rd among 155 countries surveyed with respect to ease of protecting shareholders rights. According to the survey Turkey receives 8 out of 10 for extent of disclosure, 3 out of 10 for extent of director liability, 4 out 10 for ease of shareholders suit resulting in an overall score of 5.0 out of 10 for ease of protecting investors.

BORYAD, the association of individual investors in listed stocks complains about the level of shareholder protection in Turkey on a report in their Web-site.[41] The report complains about nomination privileges assigned to certain group of shares, extensive use of multiple voting rights, outright transfer pricing resulting in persistent low performance of listed companies within groups against high performance of unlisted firms within the same group and abuse of minority rights by controlling shareholders by avoiding mandatory calls in the event of mergers and acquisitions. They also point out the negative consequences of inclusion of a company in Watch List by the CMB for small investors as the prices go down and controlling shareholders buy the lower valued stocks for speculative purposes. BORYAD also claims that mutual funds underperform in Turkey against the ISE overall index due to malpractices of fund managers such as fictive trading to increase their income from commissions or manipulative transactions in collusion with other market players. It recommends setting up specialized Financial Courts as a means of private ordering against abusive controlling shareholders, daily disclosure of trading volumes of funds and disclosure of fund managers' performance at the year end.

Given the ambiguity of the CC, the main document that is the basis of the shareholders rights is the Articles of Association. In 2005, only 11 of ISE-30 companies disclosed their Articles on their Web sites.

Transfer of shares is still problematic. Shareowners are required to register their ownership in the share register maintained by the board in case of nominee shares but this is sometimes required of the shares registered with the Central Registry. 23% of he companies are reported to have provisions imposing limitations on transfer of shares by

[39] For details, see the section on Information Disclosure and Audit Standards
[40] "Protecting Investors, Doing Business", WB,IFC/Lex Mundi, 2006
[41] www.boryad.org , Reports

the CMB according to the survey conducted in 2004. CMB further reports that 42% of the companies have privileged shares with nomination rights. Other practice related issues are as follows;

- Cross ownership is an issue for the effectiveness of AGMs
- Most companies have "registered capital" systems (73%) which authorize the board for an indefinite period to issue new shares up to the limit of registered capital without shareholder approval[42].
- Disclosure of material events is not sufficient
- In case of M&As, many aspects of the deal are not transparent since share purchase agreement and shareholders agreement are not disclosed
- There is no requirement to consult shareholders in case of major asset sales

Due to technical and capacity constrains, the enforcement is unsatisfactory. Most of the alleged violations of CML are reported to be related to market manipulation.

b. Functioning of Boards

Legal Framework

Joint stock companies are governed by a one-tier board by law. The board represents the company in her dealings with third parties. The board can appoint a "registered" general manager in charge of day to day management who would have fiduciary duties even if he does not sit in the board. The board may also assign some of its powers to one or more board members as "managing directors". In this case the delegated directors are liable for the matters they are authorized. Board members who do not have signatory powers are not responsible for any wrongdoings that they have not been involved. Physical meeting of the board is not required; matters may be resolved on paper. Decisions become binding upon signing the minutes in the Board Resolutions Register. Board members must be shareholders, or representatives of a legal entity shareholder[43]. There is no requirement for qualification for becoming a director except for the boards of regulated industries (banks and insurance companies etc.). Board members can not compete with the firm. Any business dealings they may have with the company have to be approved by the board.

Under law, the board is required to perform its activities with diligence, care, foresight and good faith. Their duty and responsibility is to the "company" not to the shareholders. Its members are accountable to the company for losses created by their actions, but they are not directly responsible for losses created by managers. While they are not directly responsible for transactions concluded on behalf of the company they are jointly liable for their actions if the books and records are not kept in accordance with law, dividends are not paid, general assembly decisions are not implemented without reason, negligently and intentionally fail to perform their duties defined by law or the company articles. Registered general managers are also liable for matters they have been officially authorized by the board. Board members are nominated, appointed and dismissed by the shareholders at the general assembly.

[42] Draft CC limits the period with 5 years
[43] Draft CC eliminates this requirement

Listed companies are subject to further rules. CMB's Guidelines require classification of board members as executive, non-executive and independent non-executive. They also require the board to set up an Audit Committee, and a Corporate Governance Committee in charge of developing and overseeing the CG charter of the company, as well as being responsible for nomination and remuneration of board members and senior managers. It recommends separation of the CEO and the Chairman roles and requires at least one third of the board members to be independent. Independence criteria are well established. Boards are asked to assess their performance, play a key role in setting the strategic direction and oversee the implementation. Board members are required to have sufficient knowledge and expertise to fulfill their responsibility according to the Guidelines. The Guidelines further require that the remuneration of the board and senior executives should be performance based. Relevant members of the board and the CFO must sign off the financial statements. The Guidelines recommend Cumulative Voting for board appointment, which has not been observed by any company so far. Cumulative Voting is mandatory for unlisted companies with more than 500 shareholders[44]. The Principles also calls for a Code of Ethics and requires disclosure of social and environmental and stakeholder relations policies.

The Draft CC provides a much improved and revolutionary framework for the boards. First of all the Draft acknowledges different groups of shareholders and their right to representation as explained above. It introduces the concept of individual responsibility as opposed to collective responsibility aligning the level of authority with the level of liability for individual board members. An important aspect of the Draft is the recognition of separate roles of management (execution) and control (board). It authorizes the board to delegate day to day management to executives based on an official charter. Corporate Governance Guidelines Compliance statement, which should remain accessible on the company Web site for 3 years, is a reserved responsibility of the Board. Furthermore, assurance of compliance with IFRS is defined as a collective responsibility of the Board. Board is obliged to set up Risk Assessment and Management Committees, the first of its kind in the world. The restriction of trading with the company for board members is extended to companies in which the board members have more than 20% stake. Restrictions on extending loans to the board members are reinforced.

Probably the most innovative provisions of the Draft are related with business groups. The Draft requires the disclosure of the scope of control exercised by the parent on the subsidiary company by both the parent board and subsidiary board ex-ante and ex-post respectively. According to the Draft, the subsidiary boards and the salaried managers would not be liable for the consequences of decisions made or influenced by the parent in line with the principle of matching liabilities with authority. Table 5 presents the provisions related with the transparency of group structures.

Table 5 – Provisions Related with Group Companies and Pyramidal Structures in the Draft Turkish Company law

Article	Provision	Comments
195	Provides description of controlling shareholder, parent and subsidiary, group of companies. "Operations" whether they are in	In our opinion this is one of the most important introductions in the Draft. It assumes that "control" implies and includes "management".

[44] There are significant amount of pending cases opened by minority shareholders of unlisted companies for failing to implement the cumulative voting.

	the form of a company or else (one owner) and overseas operations are included in the definition.	The opposite can not be defended. Control can be exercised through direct or indirect cascaded or pyramidal ownership structures and privileged shares. The definition includes off balance sheet operations in the group structure. The law relies on the importance of reputational risks for the groups.
199	Obliges both the parent and the subsidiary to report on the relation in between, defines "Dependence Report" as a statutory report	Forces the related party transactions and pyramidal control relations to be disclosed
201	Limits the voting rights of the subsidiary in the parent with 25%	
202-203	Abuse of control rights by the parent is prevented by law (asset transfer, transfer pricing, preventing investments and growth, sacrificing the continuity of the subsidiary for the benefit of the company). This abuse can be based on an instruction or influence.	In our opinion this is one of the most important provisions in the Draft. The Article provides for the right of the shareholders of the subsidiary to seek remedy for harms caused by the parent for AGM decisions that they have voted against
203, 204, 205	Parent board can give instructions and the subsidiary board can refuse to implement them if they lead to bankruptcy or illiquidity	Board members of the subsidiary can not be held liable for the decisions made on instruction from the parent, however such instructions can only be based on pre-defined concrete policies
208	Right to buy the minority shares	Parent has the squeeze out the minority if it has more than 95% of the shares
206	Parent company has to balance the losses of the subsidiary	This article suggests that subsidiary boards can sign contracts to transfer financial liabilities to the parent

The Draft requires that the board members have higher education, a much debated provision. It acknowledges cumulative voting and notes that it can be mandated by the CMB in the Preamble. The Draft specifies the reserved powers of the board that can not be delegated, a substantial improvement over the current law. It also requires DOL insurance and mandates the disclosure of the limits.

Practice

Boards usually consist of members and representatives of controlling shareholders. Day to day operations is delegated to professional managers. Designating one or more of the members as "managing director" (murahhas aza) who would closely supervise the "general manager" is common. Even when the general manager is included in the board and given the title so called "CEO", her authority is limited[45]. In practice, managing directors are usually family members or loyal professionals trusted by the controlling shareholders. Distrust to professionals is common.

In a survey conducted by the CMB[46] in 2004, listed companies are asked to report on their level of compliance with the CG Guidelines before compliance report made mandatory. 69% of the companied did not make any statement about the compliance with the CG Principles in their annual reports. According to the survey only 9% of the companies had established a CG committee. 78% of the boards include non-executive members but in most cases they are either the members or friends of the controlling family. The CMB reports no acknowledgement of cumulative voting. It further reports

[45] Forbes
[46] Survey results are available from CMB.

that only 4% of the boards are compensated on the basis of company performance. Only 50% of the companies prohibit the board members to compete or have business with the company despite the restrictions, 85% of companies have no qualification requirements for the board members and only 9% have a corporate governance committee. On the other hand, 71% of the companies disclose their transactions with key managers and shareholders. The CC allows the board to receive up to 5% of net profits as compensation for the board services, subject to the approval by the assembly and provided that the company pays dividends. This directorship fee is a main source of legitimate profit transfer to family members. Directorship fee for board attendance is also defined in the CC but it is rarely used. The same survey is repeated in 2006 but the results are not yet available. In a presentation on the survey, CMB reported that the disclosure on compliance was less than satisfactory. According to the survey, 61% of the companies did not provide an assessment of their internal control mechanisms, only 22% of the companies provided any explanation on major risks, and 82% of the companies did not provide any information about their Board members. CMB concluded that the majority of the companies did not understand the CG concepts and the intentions behind the guidelines.

In practice companies do not disclose much about the board and board processes. Disclosure about the functioning of the board is significantly poorer than financial disclosure or ownership disclosure[47]. This may be considered as less important since the traditional agency problems are less significant in "insider" systems, however the opacity may be an indication of informality/lack of professionalism in the functioning of the board. The fact that only 50% of the listed companies have a mission or vision statement disclosed to the public may be indicative of this lack of formalism. Indeed, Aksu and Kosedag (2005) reports using the S&P/CGFT T&D survey data that between the extreme quartiles of lowest and highest scores, companies with higher scores especially in the category of board structure and management processes disclosures, have higher returns and accounting measures of profitability. Obviously, the level of disclosure is not the cause of better performance but a proxy of the importance given to the board's role and of the existence of a formal system of governance.

Anecdotal evidence suggests that board meetings are rather short and important decisions are made by the controlling families outside the board. Research reveals that larger companies have less frequent board meetings (average 7) whereas smaller and unlisted companies have more frequent meetings (average 13). This may be because as the outsider/insider ratio increases with size, more decisions are taken outside the board by controlling shareholders. Employees of parent companies frequently sit in the boards of subsidiaries mainly for effective oversight. Often these employees are trusted members of the extended family and the number of boards they sit in may be in excess of 20.

Kocer[48] reports significant difference between the composition and the functions of the boards of group companies and non-group companies. In the Turkish context, group companies are expected to be more efficiently run as they have access to resources and expertise and they give more priority to the oversight of management of affiliated companies. This oversight is generally performed via the board members who are salaried employees of the parent whereas the boards of non-group firms focus more on monitoring the execution of board decisions. The study finds out that the average tenure for the board

[47] Ararat, Balic and Bradley (2005)
[48] Kocer 2006

members of listed companies is 8.7 years. 70% of the board members sit in more than one board and 80% of them sit in the boards of other companies within the same group. Average tenure for General Managers is found to be 7 years. This figure is lower in group companies which may indicate better oversight of management. Average board size is 6.8 and 70% of the members are insiders. Independent board members (according to the perception of the respondents) make up 13% of the boards. Independence is voted as the list important criteria in selecting board members. Only 19% of the companies have a Chairman who is not a major shareholder and 38% are the founders. The survey reveals that board members spend 36 hours a year in board meetings. 80% of the meetings enjoy full participation. The percentage of executive board members increases with the CEO tenure. Board nomination is mainly undertaken by the Chairman according to the respondents. Chairman plays the most significant role in setting the agenda for board meetings.

Yildirim and Usdiken's recent research on family owned business groups in Turkey finds out that group companies ran by successive generations have less family members and more salaried managers on their boards. According to the survey larger the firms, larger the boards and larger the percentage of family members in the boards. As expected, listed companies within the groups tend to have more outsiders on the board, however, the fact that companies run by successive generations have fewer outsiders compared to the ones run by he founders casts doubts on the role of outsiders. They may not serve as carriers of "modernization" according to the authors; outsiders are likely to be "friends". An interesting finding of the study is that board size increases with foreign ownership. Indeed foreign ownership is negatively associated with the percentage of salaried managers (professionals) on the board. Authors suggest that this may be due to the need to open up space for the new shareholders/partners.

Yurtoglu[49] also reports that more than half of the board of listed companies consist of large shareholders with the same family name if the board size is smaller than 6.

Interviews with key Executive Search firms operating in Turkey complete the picture; the request for search for board membership is unheard of. The same applies to general managers. Even when a search is commissioned for senior managers, the owners/managers may opt for a candidate recommended by a friend or a trusted advisor.

The remuneration of directors is not disclosed except the total cash benefits even though the CMB Guidelines recommend individual and detailed disclosure.

There is no insight to the board nomination process. According to CMB, 42% of the listed companies have groups of shares with nomination rights. Under law, board members can only be nominated by shareholders during the general assembly; while nomination rights prevent chaotic general assemblies - where any shareholder can nominate a director, it also negates the utility of board nomination committees and confers considerable power to single block holders. In most cases shareholder agreements specify the nominations rights assigned to share groups and the respective number of members depend on the percentage of shares owned. This practice positions boards as a coalition of interests and makes it impossible to have independent members in the board since a director nominated by a certain group of shares is considered to be the representative of the shareholders of the respective group of shares. Establishment of nomination committees may only serve as a facade unless the articles incorporate some form of recognition of the work of

[49] Yurtoglu (2000)

nomination committees by the shareholders in nominating directors. Currently it remains as a black box for the outsiders how the board members are nominated.

It is reported that the so-called "independent" board members currently sitting in the boards of listed companies are chosen from a pool of 20-25 individuals and their primary role is to advise rather than "tactfully" challenge the controlling shareholders.[50] The list includes a substantial number of ex-public servants and military officers suggesting the importance of managing relations with the state.

Prevailing view is that the board's primary responsibility is to the controlling shareholders, despite the law. For example in the case of acquisition of Yapi Kredi Bank by Koc Finans (the controlling shareholder of Koc Bank), a number of key decisions were made between respective controlling families regarding the future of the resulting entity including the treatment of the debts owed by the controlling family to Yapi Kredi Bank and the committed purchases of services from companies owned by the same controlling shareholder. Media coverage on issues on the planned merger between Koc Bank and Yapi Kredi Bank forced the CMB request information from the only possible source; the board of public Yapi Kredi Bank who responded by stating that they have not discussed any such matters in the meetings of the Board.

The practice of nominating salaried employees of the parent to the boards of the subsidiaries by the controlling shareholders is common and perhaps legitimate; however there is no disclosure requirement on how and under what restrictions they perform their role. Such salaried employees share their insight about the company's financial status and plans with the controlling shareholders, and without doubt they take executive orders from them. There is no requirement of disclosure about this dependency and privilege to information.

A survey of company Web sites and CG Compliance Reports supports demonstrates that controlling shareholders consider board committees as formalities as there is no evidence of structured procedures and charters.

c. Disclosure and Transparency

Until recently disclosure was not considered a public good in Turkey. One reason is that the users of information were limited by the state (for tax purposes) and the controlling shareholders who had privileged access to all company information. The dependency on private and internal sources of finance exacerbated this situation. Credit rating was not a regular practices and bank lending was based on personal guarantees and collateral. Persistent inflation continued to distort the financial information further in the absence of inflation adjusted accounting.

Reliability and availability of information (first of all financial information and information related with ownership structures are fundamental for a well functioning economy. Experience shows that the most effective corporate governance reforms are related with disclosure and audit standards in emerging markets.

Legal and Regulatory Framework

Current regulations regarding disclosure and transparency standards for privately owned companies are purely tax driven except companies within regulated industries where the

[50] Capital

relevant authorities impose rules for regulatory purposes. CMB regulates the accounting; reporting and audit standards, and functions for publicly held companies except regulated industries; banks and insurance. Publicly held companies are required to file financial reports with the ISE and the CMB on a quarterly basis. Annual audited financial statements must be published in at least two daily papers. Disclosure of material events is expanded by recent regulations and includes changes in ownership and management, purchase, sales or lease of assets above a certain threshold, changes in investments, ownership interests in other companies, managerial problems, block sales and unusual price fluctuations. The regulation does not apply to consolidated entities. There is no requirement to make audited financial statements available to public other than to the regulators.

The CMB and ISE must be notified of any purchases or sale of shares amounting to 1% by any acquirer (or acquirers acting in concert) who already holds 3% or more of the voting rights. Disclosure is also required in crossing the 3% threshold upwards and downwards. The directors and the general managers must comply with the ownership change disclosure requirements and must also disclose any conflicts of interests with the company. Companies who are subject to disclosure rules of foreign exchanges must disclose the same information also in Turkey. According to the related communiqué, purchase or sale of the stocks of the corporation by such persons as chairman or members of the board of directors, general directors or assistant general directors, other individuals with significant decision making authorities in the corporation, shareholders who directly or indirectly own 5% or more of the capital or voting rights, and the individuals who act with the persons cited above must be disclosed, but the terms “related party” and “people acting in concert” are not clearly explained.

Existing accounting, reporting and audit standards for privately held companies are extremely poor. CC sets minimum bookkeeping requirements but they are not helpful in preparing financial reports. Accounting regulations established by Ministry of Finance (Tax Procedural Law, Accounting System Implementation Regulation and Uniform Chart of Accounts) take precedence over all other regulations and are primarily concerned about taxation. Publicly listed companies and regulated sector companies (Banks and Insurance) are subject to more comprehensive disclosure regimes; however they have shortcomings in certain aspects. Furthermore their requirements are additional to the requirements of the Ministry of Finance. Each agency (CMB, BRSA, the Treasury and the MoF) develop its own accounting and audit requirements. For example, listed banks are subject to BRSA’s regulations, demonstrating the little appreciation of the financial information available to all market players. Under the amended CML, a Turkish Accounting Standards Board was established in 2002 as an autonomous entity under the authority of the CMB to develop national accounting standards, but its legitimacy is not supported by law[51]. TASB translated all of the existing IFRS to Turkish, but failed to use IFRS approved translation process which resulted in some “contextualization”. Principle-based approach of IFRS is not compliant with the rule –based traditions in Turkey and requires high quality and experienced professionals which Turkey currently has a shortage of.

Accounting standards issued by the CMB closely follow IFRS which became effective in the beginning of 2005. In practice many listed companies have been issuing IFRS based reports since 2003 as early adaptation was permitted, however these reports sometimes were not disclosed except to potential investors, rating agencies and institutional

[51] Draft CC provides the legal basis for an independent TSAB.

shareholders.[52] For example, after the announcement of the BRSA in the beginning of 2005 that inflation adjustment was no longer necessary (even though Turkey qualified for hyperinflation according to the IFRS), most banks did not disclose their certified accounts based on IFRS but made them available to selected investors.

The key difference between the current standards and the IAS and IFRS for listed companies is related with CG is in the area of related party transactions and consolidated financial statements. One other issue is that Turkey still qualifies for hyperinflationary economy but the Ministry of Finance declared that inflation adjustments would not be applied as of 2005.[53] As per the banks, key issues revolve also around consolidation (non financial subsidiaries are not consolidated against the provisions of IAS 27) and related party disclosures. The weaknesses on both parts add to the opacity of business groups which include a bank.

In Turkey are no general audit standards that apply to all companies. Each agency defines its own applicable standards. CMB has made significant progress in improving the audit standards during the past few years. There are 40 firms authorized to audit insurance firms, 42 firms authorized to audit banks, and 84 firms authorized by the CMB to audit publicly held companies. The authorization is based on structures rather than capacity.

TURMOB is legally mandated and authorized to issue professional licenses and set standards. It has good financial sources, however the professional standards are low; there is no requirement for continued education and licensing exams are focused on taxation issues in line with the role defined by the laws for audits. A license from TURMOB is a prerequisite for obtaining a license from CMB, BRSA or GDI to audit companies regulated by these agencies. Individuals with certain qualifications (academicians, seniority in profession, x-civil servants) are exempted from exams. The professional fees are regulated. As such the audit profession is not subject to public oversight independent of profession as required by the 8th Directive.

The Draft CC provides legal basis for the TASB as the national authority on accounting standards and it specifies IFRS as the national standards. It introduces a concept of "financial statement *and* annual report audit". Auditors are expected to audit both the financial statements and the annual report; auditing of the financial statements would be to ensure adherence to accounting and financial reporting standards as well as to the company's articles of association, auditing of annual report is expected to ensure the report represents a true and fair picture of the company's position to the shareholders. Obligation to have a Web-site with a special section dedicated to statutory shareholder communication with historical data is another reflection of intensions to improve the transparency. The provision of the Draft related with the transparency and disclosure are listed in Table 6 The proposed legislation encourages extensive use of electronic disclosure by the joint stock companies and mandates it for listed companies. The scope of disclosure is radically expanded with special provision for disclosure of related party

[52] Voluntary disclosure has been gradually improving in parallel to statutory requirements. Aksu and Kosedag (2005) surveyed the companies that are constituencies of S&P/IFC Turkey Index and found that 66% of the companies had opted for early adoption of IFRS as of 2003 voluntarily before it became mandatory in 2005.
[53] This misjudgment caused problems for companies who have been voluntarily using IFRS; the audit companies refused to certify the accounts as being compliant with IFRS if inflation adjustments were not applied. Some companies opted for not disclosing their IFRS compliant reports to the public as they would diverse from the reports prepared in accordance with the local standards and regulations. The whole situation created additional burden for companies and auditors who opt for full compliance.

transactions. It specifies different levels of approval such as conditional approval (a practice which is not in compliance with IAS).

Table 6: Major Provisions Related with Disclosure and Transparency in the Draft Turkish Company Law

Article	Provision	Comments
88, 517	Adoption of Turkish Accounting Standards based on IFRS	
398	Auditors responsibility to audit both financial statements (and compliance with the company's AoA), and the annual report	Auditors are required to warn the companies in written about the risks, article provides details
400	Auditors independence is ensured based on relations with the company's shareholders , duration of services and other services offered to the company	Auditor rotation is implied by manning the same auditor to approve the statements 6 times in 10 years. Consulting services are limited with 30% of the revenue.
402,403,404	Management letter is mandatory and to be disclosed, risks are reported separately	Detailed explanations are provided, the objective is set as "true and fair " representation
1502-1505	Web site obligations	

Practice

The CMB Survey reports that only 36% of listed companies disclose their ultimate ownership structure. The disclosure of real person owners is required only in the IPO prospectus. In many cases controlling shareholders indirectly own shares by using off-shore companies in addition to pyramidal ownership.

In practice companies comply with the disclosure requirements. CMB and ISE issue private and public warnings impose financial penalties or suspend trading by putting companies on "watch list" by limiting trading of the shares by 30 minutes. This practice is criticized since it allows the controlling shareholders an opportunity to buy back at a discount.

Majority of so called "audits" conducted in Turkey are related to "tax certification" and they differ in terms of their purpose and content of an audit. CMB's auditing requirements which are closest to the ISA also fall short of ISA and IFAC. On the other hand, some audits are conducted in Turkey accordance to ISA by big four audit firms based on the requirement of the issuers but without being subject to any regulation. Audit capacity is severely limited casting doubts about the quality of audits of reports based on IFRS.

Surveys conducted by the Corporate Governance Forum (CGFT) of Sabanci University in cooperation with Standard and Poor's demonstrate that the level of disclosure of publicly held firms even for the most liquid and largest cap companies is moderate. The survey has been conducted in 2004 and 2005 based on the annual reports and Web disclosure of 50 largest and highest valued firms in Turkey. The key findings of the survey illustrate that disclosure levels remain highest with respect to financial transparency and lowest in board structure and processes. Overall improvements in disclosure levels are greatest

among those companies that scored lowest in 2005 and disclosure levels between holding companies and their subsidiaries continue to diverge. Concerns therefore remain with respect to the transparency of groups. The banking sector shows the greatest improvement in disclosure levels as well as some of the listed companies with state participation and control has demonstrated a radical improvement in disclosure levels. This may be related to the ongoing preparations for the privatization of state shares. It has also been observed that companies' articles of association (AoA), which were not typically disclosed, are now increasingly becoming available on company Web sites, as recommended by the CMB. This is particularly important because shareholders' rights are primarily governed by the AoA. Some key deficiencies in disclosure were related with ownership structures; shareholder agreements between the holders of different classes and board nomination processes were not disclosed by any company. There was no disclosure of policies or practices related with parent control. Some key disclosures and improvements were as follows: Details of related-party transactions (disclosed by approximately 90% of companies; 60% in 2005), information on the presence of independent or non-executive directors on the board (60%; 25% in 2005), whether an audit committee exists (approximately 70%; 40% in 2005), information on the AoA (approximately 75%; 30% in 2005), information on any (in)formal voting agreements or blocks (approximately 30%; 5% in 2005), details of different types of shares (approximately 60%; 50% in 2005), a description of the board nomination process (approximately 50%; none in 2005), whether group-wide policies applicable to subsidiaries exist (no real change: less than 5% disclosure, compared with nondisclosure in 2005). Considering that the 50 companies included are arguably the best in class, the average disclosure is expected to be much lower.[54]

Promotion of better Corporate Governance standards is generally thought to benefit the firm through improved access to equity financing facilitated by reducing tunneling of wealth from shareholders. While this rationale is appropriate for developed countries, it seems a too narrow approach for emerging economies.

First of all, given the general scarcity of domestic capital in emerging countries, improved corporate governance provides a marginal improvement, if any, for accessing equity capital. Consequently, this is not a sufficiently strong incentive for firms to adopt better governance practices.

In the context of emerging economies, the links between economic development and corporate governance should be strengthened. While equity financing is important for growth of industries, and therefore economic development, competitiveness and innovation capacity are also vital attributes for growth.

We argue that current governance practices in Turkey, in particular non-separation of executive management and control functions have serious implications, possibly preventing companies to achieve their full growth potential. Below, we will first discuss two salient features of Turkish environment – culture of control and black economy – and their effects on governance. These two features are significant factors inhibiting majority owners to delegate power to professionals. We then outline growth implications of consequent amalgamation of ownership, control and executive management functions.

[54] The ROSC report on Accounting and Auditing prepared by the WB staff in 2005 provides an excellent review of the topic.

d. A culture of control

In Turkish corporations, there is a pervasive tendency that majority owners exercise excessive control over the companies. Typically, several board members take on executive oversight role, effectively limiting executive powers of professional managers. While this may be a cultural issue, the effect of weak judicial system cannot be ignored. Essentially, lack of trust to legal system renders contractual relations ineffective. Perceived inability to enforce employment contracts for punishment of wrong doing forces owners to relationship-based mode of operation, which indeed requires higher levels of direct control.

Changing the governance form is the most important challenge faced by the Turkish private sector. Managing this change will require that owner-managers relinquish their executive roles and delegate their executive powers to new professional managers - not to mention accepting the need for greater transparency. Such a system would power management to become the driving, entrepreneurial force in the company while enabling the board to monitor executive performance, and reward them accordingly. Even if owner-managers come to terms with the need for change, instituting a system of formal checks and balance and finding skilled and experienced professional managers in the local labour market will not be easy. New skills will not become available overnight and it will also take time before market forces develop the ability to replace the direct monitoring, currently exercised by block holders with specialised monitoring - namely ex-ante monitoring by investment banks, intermediary monitoring by analysts, fund managers and ex-post monitoring by takeover markets and reorganisations specialists etc.

e. Grey Economy

Black economy has been a persistent problem in Turkish business sector. For companies, the primary reason to engage in unregistered transactions is to avoid taxes. However, it should be noted that the prevalence of this practice is a consequence of weak enforcement. Clearly, in the absence of effective punishment, all companies are forced to follow the practice to remain competitive and avoid bankruptcy. Thus, the black economy is not a cultural phenomenon, but a judicial one.

We argue that practice of unregistered transactions has a significant effect on the governance of corporations. Often overlooked cost of this practice comes through lost transparency. Obviously, transparency and unregistered transactions are incompatible as such transactions can not be reported. What is not reported is directly controlled by the majority owner; minority shareholders' claim is only on the reported earnings. As a result, these companies are significantly undervalued in the market, or alternatively, control premium will be too high. Essentially these companies cannot access to equity capital at reasonable prices, thereby curtailing growth opportunities through new investments.

Less obviously, loss of transparency also affects efficiency of management at companies. First, providing incentives to managers is problematic. Because of incomplete reporting, formal and enforceable performance-based contracts can not be executed with top management. Performance-based rewards can only be paid informally. As the economic principles dictate, absence of incentive mechanisms leads to excessive monitoring.

Typically, Turkish companies are run by owners and very little power is delegated to managers.

Secondly, owners and managers can become enmeshed in the illegality of unrecorded transactions, making firing managers difficult. Under these circumstances, the primary attribute the owner looks for in a manager is trustworthiness, rather than management acumen. Combination of these factors diminishes the managerial effectiveness when transparency is lost. In his key note speech on the 24 of 2004 at Sabanci University's Family Firms and Corporate Governance Conference, Mr. Eczacibasi explained the situation with the following words; "Lack of trust in the legal process and in the validity of contracts strengthens the inclination not to trust anyone but family members….The strong personality of the founders can create very strong corporate cultures."

f. Effects of Excessive Control of Managers

On one hand, direct control of managers is beneficial as it removes the agency problem between owners and managers, which is especially important in Anglo-Saxon countries. On the other hand, however, it may lead to loss of efficiency and lower growth for the following reasons.

- Majority owners of large firms and business groups need to oversee operations of several companies at any given time. Time sharing of executive power of owners can be thought of as companies being run by part-time CEOs. This is clearly ineffective, limiting growth potential of individual firms.
- Majority owners, especially first-generation of the family, are founders with entrepreneurial talents. When they cannot transfer executive power to professionals, their entrepreneurial activities suffer, as they have to spend their time controlling the professionals.
- Furthermore, successive generations in a family may lack managerial talents. Oversight by such family members may lead to direct loss of efficiency.
- Need for direct control in firms also inhibits diversification of owners' portfolios through financial investments. Consequently, majority owners remain too risk averse for efficient investment policies. In particular, they may be unwilling to take high-risk, high-return investments opportunities, hurting innovativeness of firms.

VI. Key Recommendations

Recently, OECD Steering Group on Corporate Governance has drafted a report on corporate governance of Turkey as a pilot study. This report provides a detailed analysis of institutional framework vis a vis OECD guidelines, including some recommendations and policy options. The recommendations in this report can be summarized as follows:[55]

- Improving the potential for market disciplinary forces
    - Increase free float requirements
    - Amend the pension and mutual fund laws
    - Investor education initiatives
    - Amend tender offer laws

[55] This discussion is based on the draft report dated March 2006, which is not publicly circulated.

- Improved transparency
    - Enhance disclosure standards in key areas
    - Centralization of financial standard-setting process
    - Adopt international standards for auditing
- Improve effectiveness of regulating bodies
    - Provide more independence and penal powers to CMB
    - Adopt a risk based approach to regulation
    - Improve coordination of regulating bodies
- Improve legal protection and access to remedies

The report provides a detailed discussion of these recommendations. Rather than repeating the same analysis in an effort to be comprehensive, our strategy is to build on these recommendations. Still some of the recommendations are repeated below either for emphasis or for pointing out additional aspects. More importantly, however, we try to expand the perspective of sought out improvements. Given that the report is based on OECD guidelines, the focus of the recommendations is, naturally, minority shareholder protection. While this is certainly an important target, it is our opinion that managerial effectiveness of the firms should also be addressed.

a. Free Float Requirements

As suggested in the OECD report, we would also strongly recommend increasing free float requirements from 5-25% to at least 20-30% depending on company value. However, we would also like to point out that certain steps need to be taken to ensure that float ratio do not decrease over time. As already reported, there are small cap firms trading in ISE with less than 10% (even 1%) float ratios. There are two main mechanisms that reduce free float ratio:

1. <u>Mergers</u>: When a public merges with a private firm, float ratio is automatically reduced. In practice, these mergers occur as a transaction between majority owners of both companies and owners of public shares have no voice over the transaction as general assemblies are also dominated by the majority owners. Effectively, fairness of these transactions can only be enforced by CMB, which would be weak due to informational asymmetry. To this end, OECD report suggests amending tender offer laws to ensure that minority shareholders are treated fairly. However, this does not address reduced flotation rate of the merged company unless the company is de-listed in the process. We recommend that some level of flotation requirement is enforced through mandated secondary issues following significant mergers.

2. <u>High Priced Rights Issues:</u> It is observed some companies undertake a rights issue with a price that exceeds market price of the shares, particularly when share price falls below the nominal value of the shares. From a financial point of view, holders of shares should not subscribe to these rights issues, as the issued right has an effectively negative value. Consequently, such rights issues are only subscribed by majority shareholders, increasing their ownership of the company, and reducing flotation ratio. Clearly, this should be avoided through regulation.

b. CG Index

CMB and ISE jointly initiated a CG Index project in 2004 to provide an incentive to firms to improve their corporate governance. According to this scheme, firms that receive corporate governance rating of higher than 6 are included in this index with reduced listing fees. As of May 2006, this index did not become operational as firms did not show much interest, and the number of firms that received a rating is less than 5, which is the minimum number required for commencing the index.

While creating a corporate governance index is a commendable goal, we view the implementation as deficient. The only requirement for being included in this index is a CG rating of 6. This rating is provided by commercial rating agencies, which are registered at the CMB, using their own methodology and weighing criteria (except the respective weighing of 4 main areas which are specified by the CMB). The rating is a "compliance" rating against the CMB's Guidelines according to the relevant communiqué, not a rating of the "quality of the corporate governance regime" of the firm.

The methodologies are proprietary to the rating agencies and cannot be audited. It follows that ratings given by different agencies are not necessarily comparable. This implementation strategy therefore carries the danger that less-scrupulous rating agencies may dominate the rating market by giving exaggerated ratings. This may even result in reputable rating agencies leaving the Turkish market entirely. Even without going to this extreme, the variation in the CG quality of the companies in the index will certainly reduce the credibility of the scheme, and the index may not show the performance hoped for.[56]

We recommend that the basic requirement for inclusion in the index should be compliance assessment, rather than a rating. Compliance should be assessed against a set of requirements, which are based on CMB's guidelines selected for having critical importance and being measurable to reasonable degree. Other objective criteria such as a certain minimum floatation rate and wedge (deviation between cash flow rights and control rights) should be considered for inclusion in the index as is the case for BOVESPA. At this point as determining actual set of requirements requires careful analysis and research. However, an initiative to undertake this analysis should be started before index becomes operational. STAR and BOVESPA experiences should be closely examined with respect to suitability for Turkey.

c. Independent Board Members

It is interesting to note that OECD report lacks any recommendation related to independent board members, an issue that received wide interest elsewhere. There may be two reasons for exclusion; (i) it is already covered by CMB guidelines, although without any practical effect, and (ii) independence of board members usually remain a theoretical exercise, as members chosen by majority shareholders have little incentive to voice independent opinions for protection of minority shareholders.

Still, we believe that the issue of independent board members should remain as a focus. While this is admittedly easy to regulate but impossible to enforce, we believe that it will have a positive effect thorough its affect on corporate culture, hopefully pushing towards

[56] Other concerns that may effect the credibility of the index are: (i) compliance aspect of the rating requires an auditing competence in addition to rating competence (ii) the rating agencies operating in Turkey have limited experience and coverage in emerging markets, raising concerns about the reliability of their methodology.

more formal means of governance. Furthermore, a few success stories and attention to good practices may increase the effectiveness of independent board members in the long term.

However, there is a strong impediment for election of independent board members due to legal framework for nomination of board members. Currently, the power of nominating board members is given only to shareholders as an inalienable right. This corresponds to the prevalent view of board members as representatives of shareholder groups. Even the draft CC follows this view, effectively ignoring the basis that board members should only consider the good of the company, not just the benefits of a group of shareholders. In practice, many companies have detailed stipulations in their AoA regarding the number of board members nominated by different share groups. While CMB's guidelines call for a CG committee which should nominate board members, these conflicts with CC. Current practice of share groups with nomination rights and other blocking rights are detrimental to effective management of companies as it increases the risk of dead locks.[57]

Within this framework, an independent board member can only be nominated by a share group within their quota of board members, which essentially defeats the independence concept. We strongly recommend that the law should be amended in this matter, allowing at least independent members to be nominated by the board of directors, or a committee charged with this task.

d. Group Firms

Draft CC brings extensive disclosure requirements for firms within a business group, or in a parent-subsidiary relationship. At the same time, the code recognizes a certain power of parent firms over subsidiaries. There is certainly a philosophical problem as this view conflicts with independent legal existence of subsidiary firms. However, this becomes a practical CG concern when the subsidiary is a public company itself.

A public company should be an independent entity seeking its own benefit, and should be free from exertion of undue power by any shareholder, including the parent company unless the company law recognizes the "groups" as a special case as in German law. This issue does not receive proper attention in CMB's CG guidelines or in disclosure requirements, and should be amended. The following should be considered a minimum set of requirements for tackling this problem beyond the normal requirements of related party transactions when the subsidiary is a public company:

- Parent and subsidiary should not have the same person as board members with executive powers, including designated board members (murahhas aza). Non-executive members who are employees/officers of the parent should be disclosed and clearly designated as such.
- The Articles of Association of the subsidiary should clearly state the scope of "dependence" to the parent. Prospectuses issued at the time of IPO should also explain the nature of the "control" agreement with the parent. Furthermore any Holding company who wishes to have listed subsidiaries should explain their "added value" and "control powers" they wish to use in their Articles of Association.

[57] Case of Turkcell.

- Parent company's internal audit units should not be allowed to audit the listed subsidiary unless the results of the audit with respect to risks are shared with the public and the staff involved in the audit is included in the list of "insiders".
- Transfer of a top executive between a parent and a subsidiary company should be considered as an event that requires disclosure, similar to related party transactions

e. Transparency and Disclosure

We wish to add the following disclosure requirements to the recommendations in the OECD report for improved transparency.

- Disclosure of ultimate beneficiaries should be enforced. This information is very difficult, or impossible, to obtain independently as Turkey does not have central register for joint stock companies.
    - It would be desirable to establish a central register where ownership and financial statements for all joint stock companies becomes public information.
- The concept of "Public Interest Entity" should be introduced and all companies above a certain size and of public interest should have the same disclosure obligations as publicly owned companies.
- Disclosure of Articles of Association should be mandatory as it is the main governing document of a joint stock company.

Furthermore we strongly recommend that the experience and know how of the big international audit firms and TIDE[58] should be used by the regulators. Currently practical experience in IFRS and IAS are found only within these organizations.

f. Legal Framework

New draft laws introduce a progressive and comprehensive framework for the corporate governance regime in Turkey. It is our hope that these laws will enacted without delays, and measures will be taken to implement them effectively. Yet, enforcement remains a critical area for the overall success of the system. We advocate wholeheartedly the recommendations included in the OECD report for provision of more affordable, accessible and predictable remedies and other enforcement mechanisms.

VII. Areas for Further Research

Currently there are many reports and papers describing the state of corporate governance in Turkey. Yet, our understanding of efficiency implications of governance remains limited and does not go beyond deductive reasoning. We feel that further research is required to pinpoint the specific governance with significant effect on efficiency and growth. This is particularly important, for example, for developing the set of requirements for inclusion in the CG index as discussed above. There is an upsurge of excellent finance-law papers and the focus of CG research is shifting to controlling shareholders.[59]

[58] See Figure 5.
[59] R. Gilson, B. Black, Morck and Yeung , Dick and Zingales , P. Bolton, etc

Emerging theoretical models will provide the necessary framework for empirical studies at micro level to support policy making process.

In particular, there is a need for qualitative research to understand drivers of companies, such as,

- The changing role of business groups and holding companies
- Instruments for expropriation and entrenchment
- The role and value of non-pecuniary private benefits
- Industry/sector specific implications of controlling shareholders systems
- Dynamics of efficient controlling shareholder systems
- Better understanding of board and management practices in business groups
- Perceived reasons for resistance to adopting formal control systems rather than informal direct control
- Utilization or non-utilization of performance based contracting for top executives
- Incentives for improved transparency and better governance
- Level of trust in the judicial system

The qualitative research should in turn lead to empirical tests of CG variables found to be significant drivers of growth and firm value. Furthermore, this research would indicate whether other governance structures, such as two-tier boards, formalizing the separation of execution and control would be suitable for Turkish companies.

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Annex

Comparison of international best practices and Commercial Code CC), Capital Market Law (CML), Capital Market Communiqués (CMC) and CMB Principles

(compiled from IIF report on Turkey (2005) and CMB Web-Site)

Topic	International Standards (IIF)	**MANDATORY** Commercial Code (CC), Capital Market Law (CML), and Capital Market Communiqués (CMC) / **COMPLY OR EXPLAIN** Capital Markets Board Corporate Governance Principles (CMB Principles)
Minority Shareholder Protection		
Voting rights		
Proxy voting	Firms are encouraged to allow proxy voting.	Proxy voting allowed (CC Art. 360, details on execution outlined in CMC Ser. IV, No. 8, Art 4 et. Seq.). **2003**
		Provisions restricting proxy voting should not be included in the company's articles of association (CMB Principles Sec. I Art. 4.6). **2003**
One share one vote principle	"One share one vote" should be a threshold requirement for new issues.	May have multiple voting and non-voting shares.
		Privileges regarding voting rights should be avoided (CMB Principles Sec. I Art. 4.5). **2003**
Cumulative voting	Cumulative voting should be permitted.	Optional.
		Cumulative voting should be adopted (CMB Principles Sec. I Art. 5, Sec. IV Art. 3.4). **2003**
Capital structure		
Procedures on major corporate changes	Shareholder approval of mergers and major asset transactions should be required. If an offer is made above a reasonable minimum threshold of outstanding stock, a significant portion of that purchase must be through a public offer. Ownership exceeding 35% triggers a public offer in which all shareholders are treated equally. Under a merger or takeover, minority shareholders should have a legal right to sell shares at appraised value.	Mergers require a change in company articles of association, which requires shareholder approval (CC Art. 388). **1959** A tender offer for remaining shares is required when a shareholder's interest crosses 25%, or if initially between 25% and 50% increases by 10% or more, of voting stock within any given 12-month period or if there is change of management's control regardless of percentage of shares held. Price offered may not be less than price offered to target shares. CMB may grant exceptions in certain limited cases (CMC Ser. IV, No. 8, Art. 14 et seq.). **2003**

Procedures on major corporate changes (continued)		Shareholder approval of major decisions, including divisions and sale, purchase, pledge, or lease of significant assets, should be required (CMB Principles Sec. I Art. 3.6). The information about tender offer should be disclosed immediately (CMB Principles Sec. II Art. 1.11.5, 6) **2003**
Capital increase (pre-emptive rights)	Shareholders approval is required. Any capital increase over a period of 1 year and above a minimum threshold must first be offered to all existing shareholders.	In a capital increase, shareholders are generally entitled to subscribe for new shares in proportion to their respective shareholdings. Pre-emption rights of the shareholders may be restricted wholly or in part by an affirmative vote of the holders of a majority of the outstanding share capital at a shareholders meeting (CC Art. 388). For companies that have adopted the authorized capital system (most listed companies) this authority may be conferred upon the board, which is required to apply such restrictions equally with respect to all shareholders (CML Art. 12). The power to restrict the rights of shareholders obtaining new shares may not be used in a way causing inequalities among the shareholders (CML Art. 12). **1959 and 1992**
Share buybacks	Details of share buybacks should be fully disclosed to shareholders.	Not permitted, save for certain limited exceptions (CC Art. 329). **1959**
Shareholder meeting		
Meeting notice and agenda	Meeting notice and agenda should be sent to shareholders within a reasonable amount of time prior to meetings.	Notice and relevant documents should be given to shareholders at least 15 days in advance of all shareholder meetings (CC Art. 368). **1959**
		Extensive details on notice and agenda listed (CMB Principles Sec. I Art. 3). **2003**
Special meetings	Minority shareholders should be able to call special meetings with some minimum threshold of the outstanding shares.	Shareholders holding at least 5% of share capital can call special meeting (CC Art. 366, CML Art. 11). **1959 and 1992**
Treatment of foreign shareholders	Foreign shareholders should be treated equally with domestic shareholders.	All shareholders, including minority and foreign shareholders, should be treated equally (CMB Principles Sec. I Art. 8.1). **2003**
Conflicts between shareholders	Should have mechanisms whereby a minority shareholder can trigger an arbitration procedure to resolve conflicts between minority and controlling shareholders	5% of share capital may ask a shareholders' meeting to appoint a special auditor to examine alleged abuses. If shareholders' meeting violates rules, shareholders may directly petition court for appointment of a special auditor (CC Arts. 348, 356, 367, 381 et seq., CML Art. 12). **1959 1992**
		The board, corporate governance committee, and an investor relations department should facilitate the exercise of shareholder rights, including protecting minority shareholders (CMB Principles Sec. I Art. 1, Sec. IV Art. 1.5). **2003**
Quorum	Should not be set too high or too low. Suggested level would be about 30% and should include some independent non-majority-owning shareholders.	In general, quorum is 25% of share capital, with no quorum for adjourned meeting. For amending articles, 50% with 33% (1/3) for adjourned meeting (CC Arts. 372, 388).**1959**

Structure and Responsibilities of the Board of Directors		
Board structure		
Definition of independence	Cannot have a business or personal	No provision.

	relationship with the management or company, and cannot be a controlling shareholder such that independence, or appearance of independence, is jeopardized.	7 criteria for independent directors, including not having any direct/indirect relationship with the company, not holding more than 5% of total share capital, not having been previously elected to represent special shareholder group, not having served on board for more than 7 years, not have been employed by external auditor (CMB Principles Sec. IV Art. 3.3.5). **2003**
Share of independent directors	At least one-third of the board should be non-executive, a majority of who should be independent.	No Provision Majority of the board should be non-executive. At least one-third should be independent, with a minimum of 2 (CMB Principles Sec. IV Arts. 3.2.1; 3.3.1). The board chairman and chief executive officer is not the same person and that majority of the board should consist of non-executive members (CMB Principles Sec. IV Art. 3.2.1). **2003**
Frequency and record of meetings	For large companies, board meetings every quarter, audit committee meetings every 6 months. Minutes of meetings should become part of public record.	No Provision Board should meet at least once a month. Decisions of the board should be recorded in the minute book (CMB Principles Sec. IV Arts. 2.16.2; 2.17.5; 2.19.1). **2003**
Quorum	Should consist of executive, non-executive, and independent non-executive members.	The meeting quorum of a Board of Directors under Turkish law is constituted by the presence of half plus one more of directors of a joint stock company. The decision quorum is the majority of the board members present in a meeting (CC Art. 330). **1959** Quorum should be included in the articles (CMB Principles Section IV Art. 2.18). **2003**
Nomination of directors	Should be done by nomination committee chaired by an independent director. Minority shareholders should have mechanism for putting forward directors at Annual General Meeting (AGM) and Extraordinary General Meeting (EGM).	Shareholders of at least 10% of share capital may put forward a nominee for the board at AGM or SGM (CC Art. 366). **1959** Board should have a corporate governance committee that nominates directors chaired by independent director with majority of independent directors (CMB Principles Sec. IV Arts 5.2, 5.3. 5.7). **2003**
Term limits for directors	For large companies, re-election should be every 3 years with specified term limits.	Board must have a minimum of 3 directors elected for a maximum term of 3 years (CC Arts. 312, 314). **1959** Independent members cannot serve for 7 years or more (CMB Principles Sec. IV Art. 3.3.4). **2003**
Board committees	The Board should set up 3 essential committees: nomination, compensation and audit.	Audit committee consisting of a minimum of 2 non-executive directors supervises company auditing (CMC Ser. X, No. 16 Art. 28/A). **2003** Should have audit committee chaired by an independent director with a majority of non-executive directors and a corporate governance (which covers issues of nomination and compensation) committee with a majority of independent directors (CMB Principles Sec. IV Arts. 5.2, 5.3, 5.6, 5.7).**07/2003**
Disclosure		

Disclosure of information that affects share prices	Any material information that could affect share prices should be disclosed through stock exchange. Material information includes acquisition/disposal of assets, board changes, related party deals, ownership changes, directors' shareholdings, etc.	Public discloser should be made of a wide variety of events including acquisition/disposal of assets, board changes, related party deals, ownership changes, directors' shareholdings, etc. (CMC Ser. VIII, No. 39). **20/07/2003**
		Any developments that affect value of the company's capital market instruments should be disclosed to the public without delay. In addition to legally required disclosure, company should disclose any information that may affect decisions of shareholders and investors (CMB Principles Sec. II Arts. 1.3; 1.12). **2003**
Procedures for information release	Through local exchanges and as best practice, through company website.	Information to be released through the exchange and, if deemed necessary by the Exchange board, through media or electronic means (CMC Ser. VIII, No. 39, Art. 16). **2003**
		Company's website should be actively used as a means of public disclosure (CMB Principles Sec. II Art. 1.11). **2003**
Remuneration of directors	Should be disclosed in annual report. All major compensation schemes, including stock options, should be fully disclosed and subject to shareholder approval.	All compensation of directors is determined in the articles of association or at the annual meeting (CC Arts. 333, 369). **1959**
		Remuneration of directors, including share options, should be disclosed in annual report (CMB Principles II Art. 3.2.2). **2003**
Other responsibilities		
Conflict of interest	Any potential or actual conflicts of interest on the part of directors should be disclosed. Board members should abstain from voting if they have a conflict of interest pertaining to that matter.	Director must inform the board of any conflicts of interest and may not participate in deliberations on the matter. They may not without permission from shareholders enter into business relations with the company either directly or indirectly unless permitted by the general assembly (CC Arts. 332, 334, 335). **1959**
		Board members not permitted to attend the board meeting that may concern his/her interests (CMB Principles Sec. IV Art. 2.20) **2003**
Internal control and risk management system	Should be a function of the audit committee.	Audit committee is required to supervise management and effectiveness of the internal control system (CMC Ser. X No. 16 Art. 28/A) **2003**
		Board should establish internal control and risk management mechanisms. Audit committee should supervise the execution of the company's internal control system (CMB Principles Sec. IV Art. 1.3.2; 5.6.4). **2003**

Investor Relations	Should have an investor relations program	No provision.
		Extensive provisions for investor relations department associated with chair of corporate governance committee (CMB Principles Sec. I Art. 1.1). **2003**
Social responsibility and ethics	Make a statement of policy concerning	No provision.

	environmental issues and social responsibility.	Ethical rules should be prepared by board, disclosed to the public, and information on such rules provided to general assembly. Company should be considerate of its social responsibility (environment, public health, consumer protection, etc) and act in accordance with its ethical rules (CMB Principles Sec. III Art. 6; 7). **2003**
Accounting/Auditing		
Standards		
National/international GAAP	Identify accounting standard used. Comply with local practices and use consolidated accounting (annually) for all subsidiaries in which sizable ownership exists.	IFRS must be used with inflation adjustment (CMC Ser. XI No. 20 Art. 9; Ser. XI No. 25 Arts. 378 et. seq.).**2004**
Frequency	Semi-annually audited report at end-FY.	Companies should present financial statements to CMB and exchange on a quarterly basis. They should also have their end-year and mid-year financial results audited by external auditors (CMC Ser. XI No. 1 Arts. 48, 49; Ser. XI No. 3 Art. 10). **2003**
Audit quality	Independent public accountant. As a best practice, auditors should adhere to the global standards devised by the International Forum on Accountancy Development (IFAD).	Companies must be independently audited by auditors certified by CMB. Auditors are liable for civil sanctions if they mislead investors ((CML Art. 16/4) (CMC Ser. X No. 16 Arts. 32, 45). **2003** Audit firm may only be appointed for a maximum period of 5 years (CMC Ser. X No. 16 Art. 24) **2003**
		Audit firm must be independent and subject to regular rotation a maximum period of 5 years (CMB Principles Sec. II Art. 4.1-2). **2003**
Audit committee		
Audit committee	For large firms, must be chaired by qualified independent director with a financial background	Audit committee consisting of a minimum of 2 non-executive directors to supervise company auditing is required (CMC Ser. X No. 16 Art. 28/A). **2003**
		Audit committee should be chaired by an independent board member and the majority of members should be non-executive. All board members should be capable of analyzing and interpreting financial statements and reports (CMB Principles Sec. IV Arts. 3.1.5, 5.2, 5.3). **2003**
Relationship/communication with internal and external auditors	Committee should approve services provided by external auditor. Breakdown of proportion of fees paid for each service should be made available in annual report.	Audit committee supervises appointment, services and any work by independent auditors (CMC Ser. X No. 16 Art. 28/A). **2003**

Relationship/communication with internal and external auditors (continued)	Communication with auditors should be without executives present. Contemporaneous provision of audit and non-audit services from the same entity should be prohibited.	Audit committee should supervise external auditor of the company. Appointment and activities of the external audit firm should be under the surveillance of an audit committee. Audit committee should be able to invite executives, internal and external auditors to its meetings. Audit firms are not permitted to provide consultancy services to the company to which they provide external auditing services within the same period (CMB Principles Sec. II Art. 4.3.1; Sec. IV Arts. 5.6.1; 5.6.3; 5.6.4; 5.6.5). **2003**
Transparency of Ownership and Control		
Buyout offer to minority shareholders	Ownership exceeding 35% triggers a buyout offer in which all shareholders are treated equally.	See section on procedures on major corporate changes above.
Related-party ownership	Companies should disclose directors' and senior executives' shareholdings All insider dealings by directors and senior executives should be disclosed.	Detailed information about related party transactions should be included in the company's financial statement (CMC Ser. VIII, No. 39). **2003** Insider trading is punishable by administrative and penal sanctions (CML Art. 47). **1992** "Disguised profit transfers" among related parties are subject to administrative and penal sanctions (CML Arts. 15/7, 46, 47/A). **1992**
		Board members, executives, and shareholders who own directly or indirectly 5% of the company's capital should disclose all company capital market instrument transactions (CMB Principles Sec. II Art.2.3). **2003** To prevent insider trading, a list of the names of executives and other persons who can potentially possess price-sensitive information should be disclosed to the public (CMB Principles Sec. II Art. 5.2). **2003**
Minimally significant Shareholders	Shareholders with minimally significant ownership (greater than 3-10%) of outstanding shares must disclose their holdings	Changes in direct or indirect ownership of 5%, 10%, 15%, 20%, 25% 33⅓ %, 50%, 66⅔%, 75% or more of total voting rights or capital must be disclosed (CMC Ser. VIII, No. 39, Art. 5). **2003**

FIGURES

Figure 1. 20 year history of Istanbul Stock Exchange. ISE100 index in US$ is shown as average of beginning and ending index values, bars show average daily trading volume.

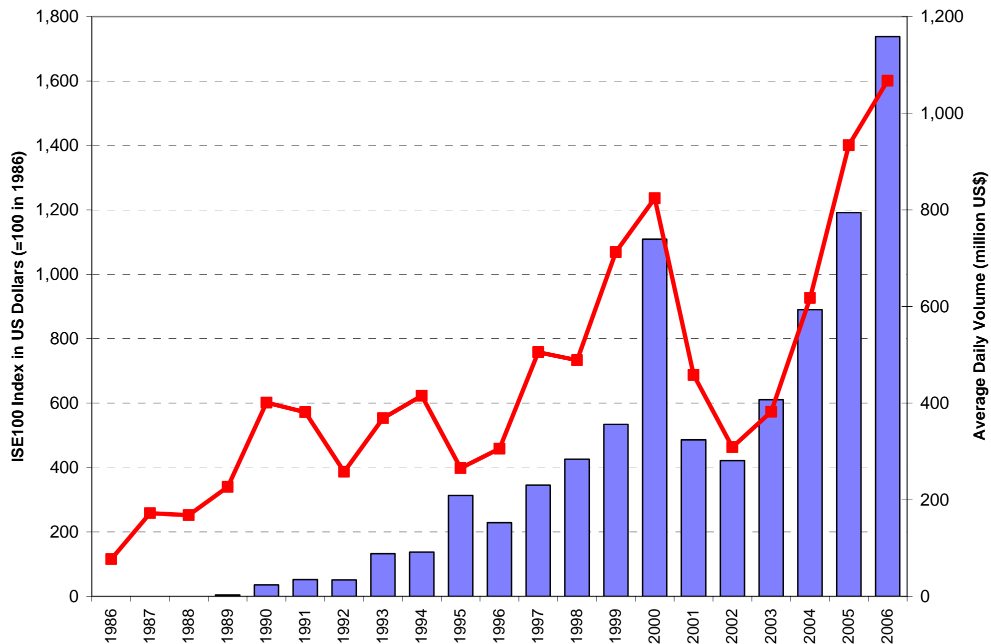

Figure 2: Growth of Pension Funds

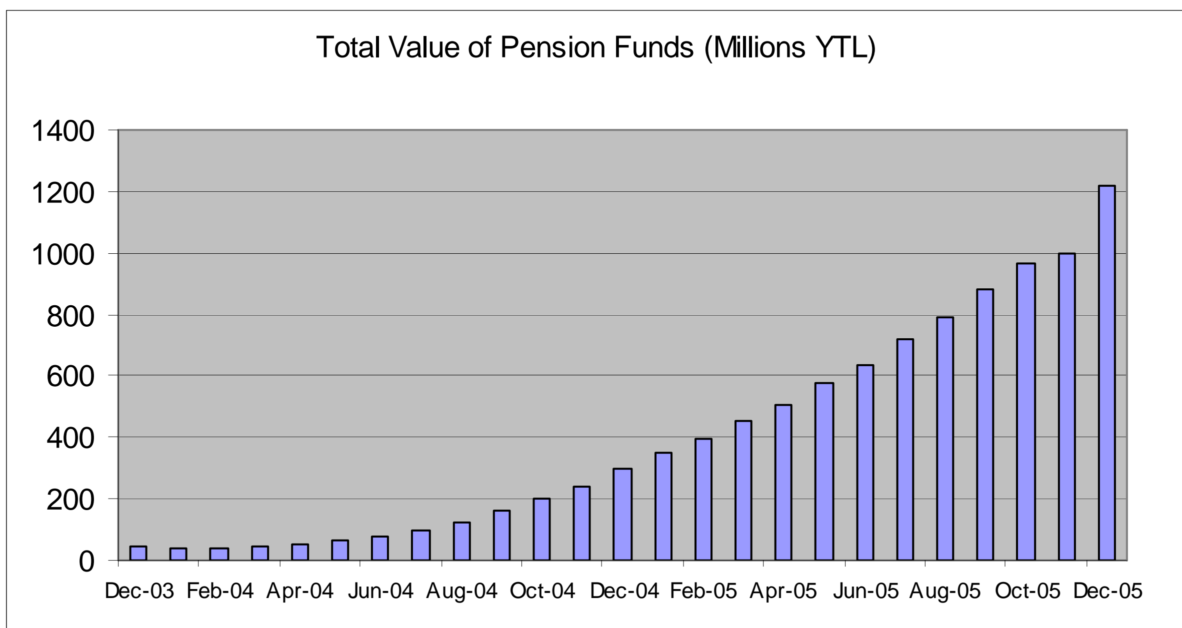

Figure 3. Distribution of flotation ratios of public corporations

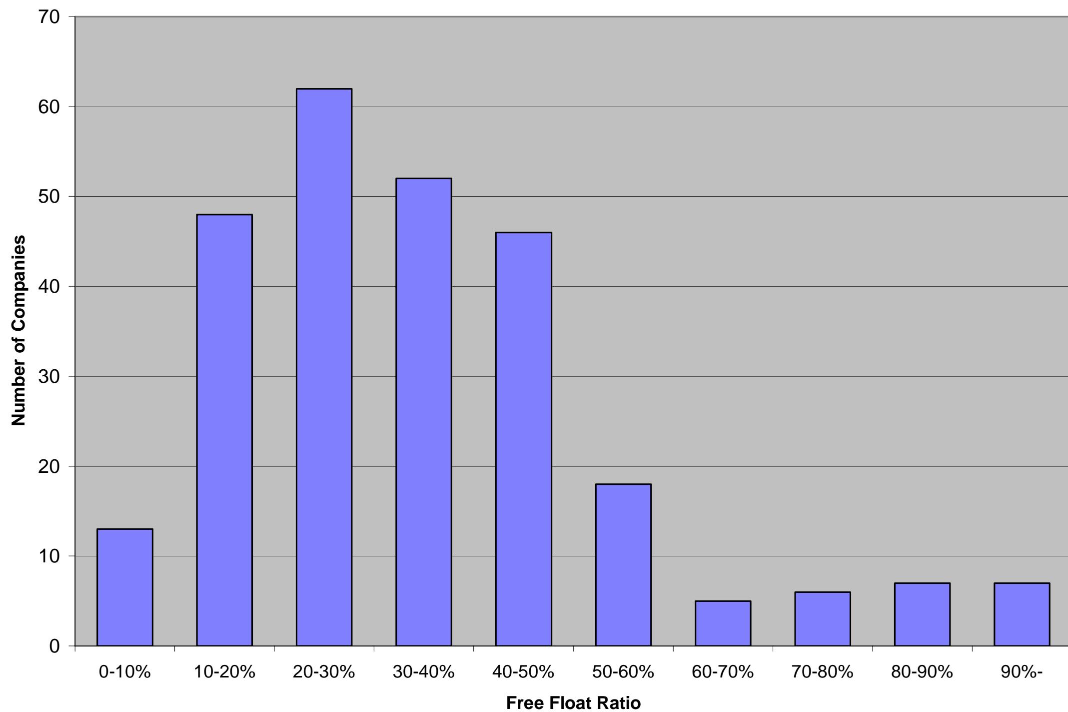

Figure 4. IPOs and value of issued equity at ISE

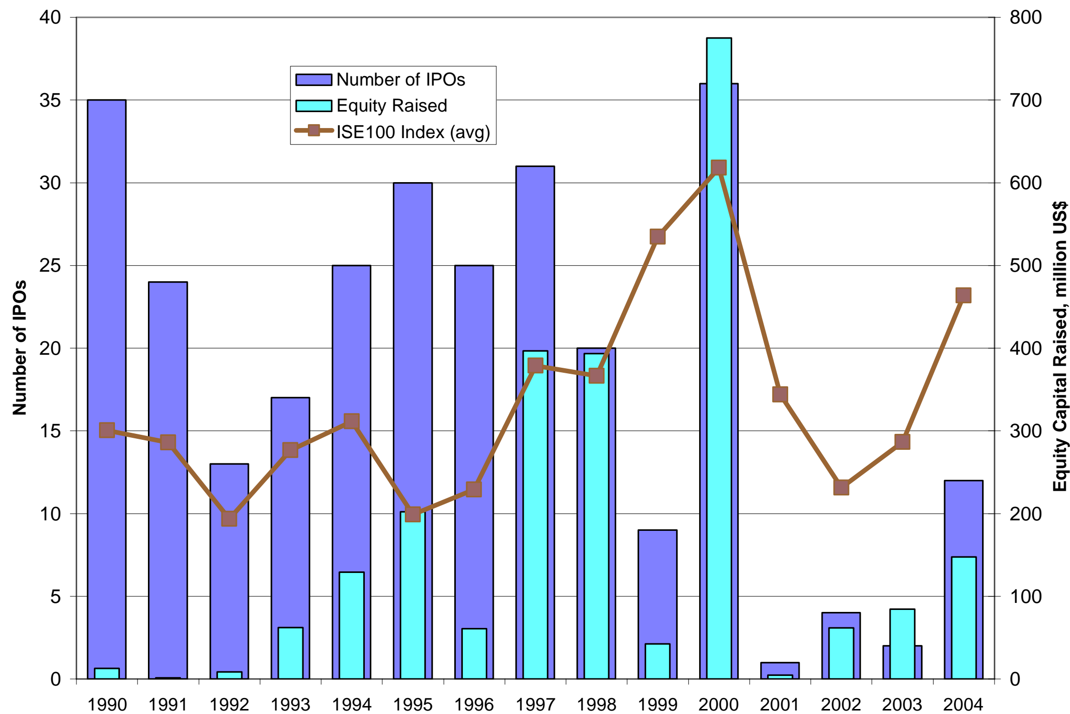

Figure 5. Distribution of certified internal audit professionals

Certification	Number of Certified Professionals and their employers
CIA	131 (46 Banks, 15 government, rest are holdings and big 4 auditors)
CFSA	9 (Banks)
CCSA	8 (Banks)

Source: Own compilation from TIDE's records

Figure 6. Net equity flows to corporations at ISE