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ABBREVIATIONS

Capital Markets Board	:	CMB
Capital Markets Law	:	CML
Central Eastern Europe	:	CEE
Chief Executive Officer	:	CEO
Company Law Action Plan (Modernizing Company Law and Enhancing Corporate Governance in the European Union- A Plan to Move Forward)	:	CLAP
Corporate Governance Principles of Turkey	:	CGP of Turkey
Corporate Social Responsibility	:	CSR
European Coalitions For Corporate Justice	:	ECCJ
European Commission	:	EC
European Corporate Governance Institute	:	ECGI
European Union	:	EU
Financial Services Action Plan		FSAP
Foreign Direct Investment	:	FDI
Gross Domestic Product	:	GDP
High Level Group of Company Law Experts	:	HLG
International Accounting Standards	:	IAS
International Accounting Standards Board	:	IASB
International Financial Reporting Standards	:	IFRS
International Labor Organization	:	ILO
International Monetary Fund	:	IMF
International Organization of Securities Commissions	:	IOSCO
International Standards of Auditing	:	ISA
Istanbul Stock Exchange	:	ISE
Minority Shareholder Protections Index	:	MSP
National Association of Securities Dealers Automated Quotation System	:	NASDAQ
New York Stock Exchange	:	NYSE
Non-Governmental Organization	:	NGO
Organization for Economic Co-operation and Development	:	OECD
Public Company Accounting Oversight Board	:	PCAOB
Security and Exchange Commission	:	SEC
Small and Medium Enterprises	:	SME
Socially Responsible Investment	:	SRI
State-owned Enterprises	:	SOEs
The Financial Accounting Standards Board	:	FASB
Turkish Accounting Standards	:	TAS
Turkish Accounting Standards Board	:	TASB
Turkish Commercial Code	:	TCC
Turkish Industrialists and Businessmen's Association	:	TUSIAD
Union of Chambers of Certified Public Accountants of Turkey	:	TURMOB
United States Generally Accepted Accounting Principles	:	US GAAP
World Trade Organization	:	WTO

1. INTRODUCTION

Corporate governance has become the motto of the business sector for both developed and developing countries in the last two decades. The corporate scandals and collapses such as *Enron* for the US and *Parmalat* for Continental Europe pushed the button for the corporations to change their corporate behavior and restructure themselves to (re)gain investor confidence and alarmed the governments to initiate radical reforms of their corporate governance and accounting rules and principles as well as making new amendments on their company law. Developing countries have also realized that foreign investors privilege the companies and countries that implement sound corporate governance. With regard to this, Turkey's challenge is of double nature: the harmonization of its company law and the related rules and regulations in accordance with the *acquis communitaire* within the EU accession process, on the one hand, and the improvement of its competitiveness in order to attract more foreign investments, on the other hand.

This study focuses on the developments and trends of the "corporate governance" issues in the European Union (EU) and in Turkey as a candidate country. As a methodology it is based on a comprehensive assessment of three pillars which are the following aspects of corporate governance: theoretical aspects (models of corporate governance, empirical studies regarding the correlation between corporate governance and some of the economical and financial indicators), the legal aspects (Directives and Recommendations of EU, regulations and codes of the EU member countries and Turkey) and the practical aspects (implementation examples of corporate governance, rating results and surveys, studies and reviews by the regulatory organizations and the academicians).

The aim of this study is:

1) To emphasize the significance, benefits and features of corporate governance in the light of empirical analysis (two-level analysis: country and company level) and theoretical models for the use of EU member states, representing developed countries, as well as for the use of Turkey as candidate country for EU membership, representing emerging countries (Chapter 2),

2) To give an overview of the EU's shifting approach on corporate governance through the Directives and Recommendations within the initiatives of the Financial Services Action Plan, Lisbon Agenda and the Action Plan on Modernizing Company Law and Enhancing Corporate Governance (corporate governance at supranational level), and furthermore to indicate the most important reforms, samples of implementations, trend issues (i.e. corporate social responsibility) and market monitoring mechanisms (institutional investors and shareholder activism) as driving forces of the EU member states and to identify the convergence and divergence areas in the corporate governance practices among EU members (corporate governance at EU member states level) (Chapter 3),

3) To understand Turkey's position regarding corporate governance in terms of regulations and implementations and recent reforms; and to provide an overview of the weaknesses and strengths, similarities and differences of Turkey compared to the EU, and finally, by using the EU Corporate Governance as a model; to highlight the completeness of the regulatory framework in line with the EU regulations and effectiveness of its implementation of Turkey (Chapter 4) and

4) To outline a number of recommendations on what should be the future priorities and initiatives of Turkey in this regard (Chapter 5).

2. CORPORATE GOVERNANCE PHENOMENON

2.1 DEFINITION OF CORPORATE GOVERNANCE

According to Sir Adrian Cadbury[1] the origins of the use of the term "governance" deriving from the Latin word gubernare meaning to steer may be traced back to the fourteenth-century English author, Geoffrey Chaucer (Maclean & Harvey 2006, p.51).

The term "corporate governance" was used for the first time about 25 years ago and in the course of time it has been accepted as a common key principle and its importance as a guideline for corporations and the role of this "phenomenon" for the success of the market economies is undeniable.

However, the definition of "corporate governance" remains controversial since there is no single universal definition. Because it relates to a large number of economic, financial and social determinants, the definition has to cover multi-dimensional aspects. Therefore, many different approaches for the definition of "corporate governance" can be found.

Sir Adrian Cadbury defined corporate governance in the Global Corporate Governance Forum (2000) as follows:

> *Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society*.

According to the Cadbury Report of 1992, corporate governance is more broadly defined as "basically the system by which companies are directed and controlled".

The Organisation for Economic Co-operation and Development (OECD), which is actively co-ordinating and guiding the work on corporate governance, states in the Preamble of its Principles of Corporate Governance (2004, p.11):

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[1] Former chairman of Cadbury-Schweppes and chairman of The Committee on the Financial Aspects of Corporate Governance also referred to as 'Cadbury Committee', which produced the seminal "Cadbury Report" in the UK in December 1992.

Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The International Chamber of Commerce (ICC) describes corporate governance as:

the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations. (www.iccwbo.org./corporate-governance/)

In the literature, some of the main features of corporate governance are enumerated as follows (Plessis, McConvill & Bagaric 2005, p.8):

1. Corporate governance is a process of controlling management.
2. The interests of internal stakeholders as well as the other external parties such as creditors, regulators, unions who can be affected by the company's conduct are taken into consideration.
3. It aims to ensure responsible behavior by corporations.
4. Corporate governance's ultimate goal is to achieve the maximum level of efficiency and profitability for a corporation.

According to the *King* Report on Corporate Governance for South Africa of 2002, there are 7 characteristics of good corporate governance:

1. Discipline;
2. Transparency;
3. Independence;
4. Accountability;
5. Responsibility;
6. Fairness;
7. Social responsibility.

It should furthermore be underlined that there is a difference between "corporate governance" and "management"; the latter refers to day-to-day running of a business, while corporate

governance refers to rules, regulations and best practices which ensure accountability, transparency and fairness (Derman 2004, p.10).

Taking into consideration the above mentioned definitions, corporate governance can be described as an on-going trust-building process among all the stakeholders for the long-term success of a company. As more companies implement these rules and best practices, its aggregated impact and success will be reflected in the overall economy of a country. Moreover, with regard to the driving force of globalisation, as well as the prevalent implementation of liberal market-economy, the corporate governance principles and best practices will be embraced as a "natural corporate behavior" in the future.

2.2 DRIVING FORCES OF CORPORATE GOVERNANCE

The following factors can be identified as driving forces for the implementation and improvement of corporate governance rules and principles:

a. Financial crises and corporate scandals;
b. Globalization and international capital market integration;
c. Liberal market economy and deregulation;
d. Foreign Direct Investment;
e. Privatization;
f. Mergers and acquisitions trends and takeovers;
g. Company Ratings;
h. Growth of institutional investors such as pension fund and mutual funds (Derman 2004, p.33).

Financial crises and corporate scandals highlighted the significance of weak practices resulting in serious harms and damages in the economy and a collapse of stock market values. After the financial crises in 1998 in Russia, Asia and Brazil, governments have realized that deficiencies in corporate governance endanger the countries' stability and health of its financial system.

Just a few years after these global financial crises, accounting scandals at prominent companies in US, such as *Enron* (2001), *Tyco* (2002), *WorldCom* (2002), *Adelphia* (2002)

and *Qwest* (2002) have shaken the confidence of all the domestic and international investors. *Enron* and its audit firm *Arthur Andersen* became the symbol of poor governance and unethical conduct. Because of its very well planned audit fraud and corruption, *Enron* became the wakening force of policymakers and corporations and will be remembered as the biggest bankruptcy in the American history. These high profile collapses were mainly related to poor transparency and management as well as related party transactions such as loans to major shareholders or the sale of assets to shareholders at low prices. The low level of transparency made it possible to hide these related party transactions and to mislead investors about the value of the company. Board members were also ineffective to prevent these transactions and were not keen on applying high standards of transparency and this resulted in a corporate collapse (Capital 2003). Many states, municipals, unions, mutual and pension funds had invested in *Enron* and other collapsed companies; and this drew an immense media and public attention resulting in the demand of an urgent improvement of the conduct of American corporations. Due to this public pressure, the so-called *Sarbanes-Oxley-Act* was passed in 2002 in the US in order to protect the investors from future corporate failures.[2]

After the US corporate scandals, the EU has also experienced some wide-ranging scandals including the *Parmalat* scandal in Italy in 2002 - also called the "Enron of Europe" - where assets to offset as much as $11 billion in liabilities over more than a decade were purely invented; a $1.2-billion fraud at *Royal Ahold*, the Dutch retailing giant; an uproar over executive compensation at *Skandia*, the Swedish Insurance Company; and accusations of fraud at *Vivendi Universal* (Landler 2003). These scandals also had a severe impact on the credibility of the countries where those scandals took place. As a result of these scandals, the EC added corporate governance issues to its agenda and presented an "Action Plan on Corporate Governance" in May 2003.[3]

In summary, deficiencies in corporate governance not only can result in corporate scandals and break-downs but also in financial crises and economic instability. It can be noticed that

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[2] Sarbanes-Oxley Act (2002) called after the Senator Paul Sarbanes and Representative of the Congress Michael Oxley who signed responsible for this Act.
[3] See also below, Section 3.1.7.

governments tend to take strict measures and to realize severe structural reforms just after each occurrence of a crisis as a driving force. Experiences also verify that these scandals and the subsequent corporate governance reforms including increased regulation and enforcement are essentially cyclical (Clarke & Rama 2006, p.33).

Institutional investors base their investment decisions primarily on the financial performance of the target company as reflected in financial reports. However, since the corporate scandals revealed that financial reports can be manipulated giving a misleading impression about the real performance of a company, investors started to focus on companies providing investor protection mechanisms and internal controls by means of corporate governance aspects of fairness, transparency, accountability and responsibility.

As rating scores, another driving force, are benchmarks of corporate risk and returns, the assessment of corporate governance practices of companies and their related ratings play an important role in investment decisions. Thus, transparency and the adoption of corporate governance in the companies can be seen as a direct effect of the work of the rating agencies which function as catalysts for good corporate governance (Derman 2004, p. 43).

A further example of a driving force for corporate governance implementation can be seen in the globalization and privatization processes. Globalization, on the one hand, leads to structural changes in the legislations, institutions and economy, and encourages countries to adjust their regimes with the new order of the world. The opening of domestic markets to foreign investors, the reduction of national barriers within the WTO framework, the liberalization of financial markets, the expansion of foreign trade, foreign direct investments and cross-boarder financial flows are direct results of the globalization process. Globalization increases the competition in the global economy and therefore both developing and developed countries are under more pressure to adapt sound corporate governance to stay competitive. Privatizations, on the other hand, bring the need to attract investors by applying good corporate governance practices in order to increase the value and performance of the privatized company (Derman 2004, p.23).

2.3 BENEFITS OF CORPORATE GOVERNANCE

In this Section we will examine the impact and benefits of "good" corporate governance for the countries on the macro-level and for the companies on the micro-level as supported by some empirical studies.

2.3.1 Country Level

As it became evident that there is a correlation between effective corporate governance and healthy global capital and financial markets as well as economic development, regulatory authorities started to scrutinize their codes, rules and principles in view of the improvement of their effectiveness to meet the new challenges. Especially countries in a transition process as well as emerging countries which are implementing a market-based economy accompanied by privatizations, the establishment of liberalized markets and other structural reforms recognized the positive impact of corporate governance on their economy. In this context, the implementation of good corporate governance enhances the transfer of technology and know-how, stimulates import and export as well as stock markets and fosters the establishment of a credible legislation and an effective and impartial judiciary system, thus building trust among investors.

In addition, the removal of restrictions on trade and ownership, the competitive pressure of globalization and increased merger activities lead to the introduction of market-friendly economic reforms and institutional changes. Moreover, according to Claessens (2006) increase in international financial integration as well as trade and investment flows brought cross-border issues in the scope of corporate governance.

Corporate governance has the following positive effects on a country's economy:

a. Improvement of country's image,
b. Prevention of outflow of domestic funds,
c. Increase in foreign capital investments,
d. Increase in the competitive power of the economy and capital markets,

e. Overcoming crises with less damage,

f. Efficient allocation of resources,

g. Higher level of prosperity and

h. Sustainable development (Corporate Governance Principles of Turkey 2003, p 2).

A large number of empirical studies and surveys have been conducted confirming these positive effects, and the following section will give a broad overview of the findings.

According to a survey conducted in 2001 by McKinsey & Company among private equity investors with activities in emerging markets, more than half of the survey respondents believe that institutional reforms are as important as a corporate level reform for the security of their investments. The investors believe that emerging markets are in more need of reforms in the field of corporate governance than markets in the US or Continental Europe. According to them, the decision to invest in an emerging market depends highly on the enforceability of (their) legal rights, the macro-economic stability of the country as well as the application of accounting standards and these areas need to be improved.

Not only the establishment of rules for the protection of investor rights but particularly the enforceability and enforcement is therefore crucial and can be strengthened by improving the integrity of the judiciary and the legal system.

According to another survey of McKinsey & Company, "Emerging Market Policymaker Opinion Survey on Corporate Governance: Key Findings", conducted in 2002, over 80 percent of policymakers think that governance reforms have had economic benefits, but also acknowledge that implementation was not fully successful. Both the investors and policy makers underline the key reform priorities at corporate and country level, however investors are more concerned about the priorities at broad country level such as pressure on corruption and establishment of property rights. Moreover, the majority of the policymakers privilege the strengthening of shareholder rights and the enforcement in future corporate governance reforms (McKinsey & Company 2002, pp. 3-9).

Countries where the judicial system is less effective and which have weaker corporate governance systems experienced much higher volatility in their capital markets and much

higher currency depreciation in global financial crises. For instance, during the East Asian financial crises in 1997, countries with weak legal institutions for corporate governance and weaker investor protection experienced exacerbated declines in their stock markets, because these countries' net capital inflows were more sensitive to negative indicators which adversely affect investors' confidence to leave the country due to the lower expected return of investment. With regard to this, *Brockman* and *Chung* (2003) found that stocks from countries with less investor protection trade at higher bid-ask spreads and exhibit thinner depths than more protected stocks in well-regulated stock markets (Claessens in, pp. 21-22).

The number of mergers and acquisitions undertaken in a country are also closely related to the strength of its corporate governance regime in terms of investor protection (Claessens 2006, p. 23).

Finally, also the level of transparency effects the functioning of the country's financial markets. *Morck, Young* and *Yu* (2000) found that poor disclosure and insider trading associates with more synchronous stock price movements, due to the higher costs for investors to collect information on the company and the lack of confidence related to the insiders' benefits (Claesssens in).

2.3.2 Company Level

Companies applying good corporate governance practices benefit from a large number of advantages. They have access to more stable sources of financing, borrow larger sums on more favorable terms than those which have poor records, and as a result have lower costs of capital. The facilitated access to external capital leads in return to larger investments, higher growth, greater employment and better research and development. Corporate governance improves the operational performance through better allocation of resources and better management which will create more wealth. Sound corporate governance can also be associated with the reduction of risk of fraud, corruption, corporate collapse and financial crises (OECD Principles of Corporate Governance 2004, p. 11).

The corporate governance practice influences how the objectives of the company are set and achieved, how risks are monitored and assessed and how performance is optimized (Plessis et al. 2005, pp. 3-13).

In sum, good corporate governance implies the following benefits for companies:

a. Low capital cost,
b. Increase in financial capabilities and liquidity,
c. Ability to overcome crises more easily,
d. Enhanced level of shareholder protection,
e. Increase in credibility of company,
f. Mitigation of risks such as fraud and corruption,
g. Better reputation (Corporate Governance Principles of Turkey 2003, p. 2).

The beneficial effects of corporate governance are not only limited to publicly held companies whose shares are traded in the stock exchange and seek for external capital, but extent to all kinds of companies such as state-owned/foreign-owned/ family-owned small and big companies (Oman et al. 2006, p. 41). This understanding is confirmed by the existence of a separate set of standards and good practices on corporate governance established by the OECD particularly for state owned enterprises (SOEs) in 2005[4] and the setting up of the Global Network for Corporate Governance of Non-Listed Companies (NLCs).

Many research and empirical studies have been conducted to examine the correlation between good corporate governance and a firm's operational performance, cost of capital and reduced risk of financial crises.

According to a survey by McKinsey & Company in 2001 on investors' opinion on emerging markets, investors believe that family-owned companies resist governance reforms, because the latter are not convinced that these reforms are in their own interest.

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[4] See also Section 2.5.

Thus, investors expect these companies to improve their governance in terms of disclosure, accurate reporting, enhancing shareholder rights, board evaluation and compensation.

According to another survey of McKinsey & Company on emerging market investor opinion in 2001, accounting disclosure and shareholder equality are the key priorities for improved corporate governance in corporate level for both the investors and policymakers.

The World Bank study on corporate governance, investor protection and performance in emerging markets (Klapper & Love 2002) states that there is a high correlation between corporate governance and both a company's operating performance and its market valuation. It has been concluded that one standard deviation change in corporate governance practices resulted in an average increase of 23 percent in the company's valuation; and moreover investors are willing to pay a premium for companies with good corporate governance practices. A 2001 survey by Credit Lyonnais Securities Asia on 495 companies in 25 emerging markets also indicated that shares of companies with high corporate governance standards have enjoyed higher Price/Book valuations. Moreover, the mentioned survey also found out that in the 3 year period of 1999-2001, emerging market companies in the top quartile of corporate governance standards generated an average return to shareholders of 267 percent, whereas for average companies this number is 127 percent, and companies in the bottom quartile this average return is only 49 percent (Gill 2001).

Another study has been made to assess the stock performance of listed companies from Korea, Malaysia, Philippines and Thailand, with the result that companies with higher transparency through disclosure and higher outside ownership concentration perform better, including their performance during financial crises (Claeesens 2006, p.21).

Studies also prove that if there is poor corporate governance in terms of weak legal system and high corruption, the growth rate of small firms will be adversely affected. In other terms, in countries with better protection of shareholder rights and property rights, companies will have greater access to capital which will lead them to grow faster and on the other side, in countries with weaker property rights, the cost of capital for the companies is higher (Claeesens 2006, p.17).

2.4 CORPORATE GOVERNANCE MODELS

Basically, we can differentiate between two corporate governance models. On the one hand, the so-called shareholder-oriented "outsider model" (2.4.1), which prevails mostly in Anglo-Saxon countries, and on the other hand, the stakeholder-oriented "insider model" (2.4.2), that can be found in most of the other countries in the world. The latter is sub-categorized into the Germanic model (2.4.2.1), the family/state-based model (2.4.2.2) and the Japan-based model (2.4.2.3).

2.4.1 The Outsider Model

The basic idea behind the outsider model, also known as "Anglo-American model", "shareholder model" or "dispersed ownership model", is that shareholder wealth maximization is the dominant and sole function of corporations, because shareholders (principal) are the rightful owners of a company. Consequently the role of the managers, as the agents of shareholders, is to serve the interests of the shareholders and to maximize the market price of the shares of the company (Rebérioux 2007, p.59). This model, mostly seen in UK, Ireland and the US, is characterized by a widely dispersed (non-concentrated) shareholder ownership structure with shareholders not being affiliated with the corporation (called as "outside shareholders" or "outsiders") and by a well-developed legal framework defining the rights and responsibilities of the three key players which are the management, the directors and the shareholders (Geoffrey 2008).

This model provides the following features:

a. Recognized primacy of shareholders interests in the company law;
b. Dispersed equity ownership; most of the shares are in the hands of dispersed groups of the individuals and especially institutional investors;
c. Separation of owners and management;
d. Strong emphasis on the protection of minority rights in securities regulations;
e. Preference for the use of public capital;
f. High disclosure standards.

The shareholder model is shown in the below figure:

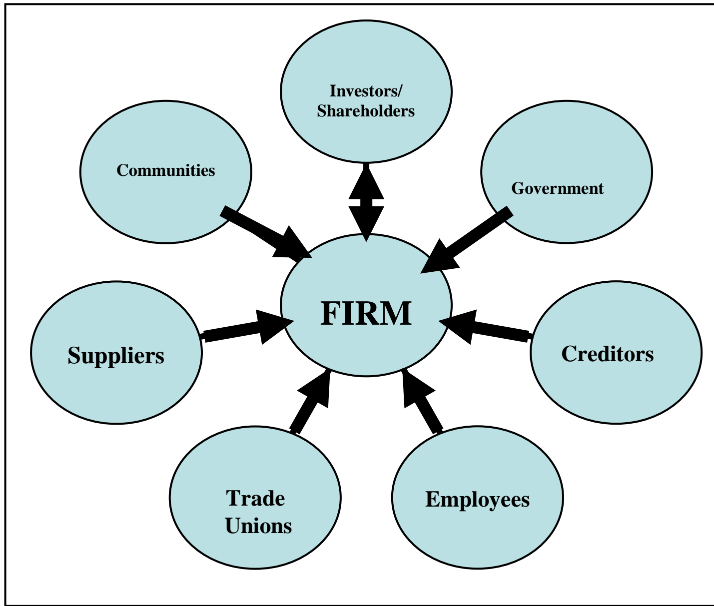

Figure 2.1 : The shareholder model

Source : Shleifer, A. Vishny, R.A., "Survey on Corporate Governance", cited in A. Osman Gürbüz, Yakup Ergincan, Kurumsal Yönetim:Türkiye'deki Durumu ve Geliştirilmesine Yönelik Öneriler (2004), p 11.

The separation of owners and managers and the dispersed ownership, providing that no single shareholder owns more than a small portion of the firm's shares, causes the so-called "principle-agent problem". Because of the existence of asymmetric information, managers may pursue objectives and strategies which suit them the most and maybe not in favor of the "principle". For instance managers may prefer to have goals such as over-investment or unsustainable growth in pursuit of their power and prestige, rather than maximizing the profit of the company leading to a conflict of interest. To reduce the effects of the principle-agent-problem, the model provides mechanisms such as incentive-based payment and stock-option remuneration for the board members and the thread of hostile takeovers in case of poor management (Oman et al. 2006 and Clarke & Rama 2006, p. 29).

This model is based on strong and liquid capital markets with high market transparency and low debt/equity ratios, as it is the case in the New York Stock Exchange (NYSE) and the

London Stock Exchange (LSE) and banks having an arm's length relationships with corporations due to the restrictions of the legislation of Anglo-American countries (Nestor & Thomson 2006, pp. 6-10).

The highly dispersed ownership structure requires that the shareholders receive adequate and on-time information in order to make rational investment decisions. Hence, the disclosure requirements of publicly listed companies and the related liability of the board members are high in Anglo-American countries (Nestor & Thomson 2006, p.6). This is due to the characteristics of the "common law" legal system, which generally provides a higher degree of shareholder protection compared to the "civil law" system of Continental Europe (Owen et al. 2006, p.4). This has been underlined by the US "Sarbanes-Oxley Act"[5] providing civil and criminal penalties for filing misleading financial reports, regulating the oversight of the accounting profession and determine the roles and duties of the audit committee and auditors, as well as of directors, including even foreign companies with 300 or more individual shareholders based in the US (Maclean & Harvey 2006, p.209) and foreign public accounting firms preparing audit report for US companies (Dewing & Russels 2004).

Another feature of the outsider model is the dominance of institutional investors such as insurance companies and pension funds among the shareholders. These institutional investors whose number is increasing in the UK[6] and the US[7], are seen as the key actors of corporate governance and have an active role in fostering corporate governance standards. The National Association of Pension Funds (NAFT) in the UK and the California Public Employees' Retirement System (CalPERS) in US are prominent examples of active investors, who as a result of their fiduciary responsibilities closely monitor the management of the corporations that they invest in and also list their own governance requirements.

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[5] US Public Company Accounting Reform and Investor Protection Act of 2002, enacted in July 2002.

[6] According to the National Statistics 2006 Share Ownership Survey, institutional shareholders which are mainly comprised of insurance companies and pension funds, accounted for 41.1 per cent of the UK ordinary shares, with a combined value of £762.8 billion, see "A report on ownership of UK shares as at 31st December 2006", *National Statistics*.

[7] In parallel to UK, US institutional investors as a whole have also increased their share of U.S. equity markets from 37.2% in 1980 to 51.4% in 2000 and then even rose to 61.2% in 2005, see "U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations" published on *The Conference Board Press Release* (2007).

Discrepancies between UK and US

Although the UK and the US share many common features of corporate governance structures, there are divergence areas as well. The most significant divergence is that while the US has a rules-base approach, rigidly defining exact provisions that must be adhered to, the UK has a principles-based approach in the sense that it provides general guidelines of best practice and is founded on self-regulation backed by codes and guidelines. The first recognized set of corporate governance principles in UK – the *Cadbury* Code – based on the *Cadbury* Report were developed in 1992 and resulted in the Combined Code of 2000[8] and are used as a benchmark for many countries, especially in Continental Europe (Maclean & Harvey 2006, p. 211). The Combined Code firstly introduced that public listed companies should disclose if they have complied with the code, and provide a reason if they have not applied the code, the so-called "comply or explain" approach. Although the compliance to the code is voluntary, the disclosure of the statement of compliance to be included in each annual report is required by the Listing Rules under the UK Financial Services and Market Act of 2000 (Waring and Pierce Ed. 2005, pp.165-167). Thus, in contrast to the statuary regime of the US *Sarbanes-Oxley* Act, UK approach considers that it is the best to leave some flexibility to the companies.

Other differences lie in the role of the CEO and the chairman of board. While in US companies the CEO is usually the full time manager with a seat on the board and at the same time also its chairman. However, in UK[9], the functions of CEO and member or Chairman of the Board are separated (Waring & Pierce Ed. 2005, p.163). Besides, shareholders in the UK, to the contrary of US shareholders, have extensive rights and can for example demand an extraordinary general meeting[10] or vote on the dividend proposed by the board. This leads UK to stronger institutional investors and more active takeover market (Rickford 2006, p.26, 29).

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[8] Combined Code: Principles of Good Governance and Code of Best Practice, Committee on Corporate Governance, UK.

[9] According to the *Higgs* Report in 2003, only 5% of the largest 100 companies (FTSE 100) have a joint chairman and CEO.

[10] Shareholders holding 10% of the shares have residual power to demand extraordinary general meeting in UK.

2.4.2 Insider Model

The basic idea behind the "insider model", also known as "stakeholder model" or "social model of corporate governance", is that the corporation must be run not only in the interest of the shareholders, but for all stakeholders of the company (e.g. creditors, employees, unions, governments), because the stakeholders participate in the production or the finance of the company and the company therefore has a social responsibility towards them. The insider model is prevalent mainly in Continental Europe and in Japan as well as in many developing and transition countries. This model has three sub-categories: the Germanic model based on a bank-centered system (prevalent in Germany, Austria, Switzerland, Netherlands and partly in France, Belgium and some Scandinavian countries as well as in Korea and Taiwan); the Japanese Model which is also bank-centered, but control is provided through a *keiretsu* structure; and the family-based (prevalent in Sweden, Denmark, Greece, Italy, Turkey)/state-based (prevailing in France) model (Nestor & Thomson 2006, pp.11-17; Mazullo 2008, p.9).

This model provides the following features:

a. Concentrated ownership;

b. A "relationship-based" system;

c. Interlocking networks and committees;

d. Different form of pyramidal structures;

e. Weak securities markets;

f. Low transparency and disclosure standards;

g. High debt/equity ratios, with a higher rate of bank credits (Clarke & Rama 2006, p.29).

Insider model diagram is shown in below Figure 2.2:

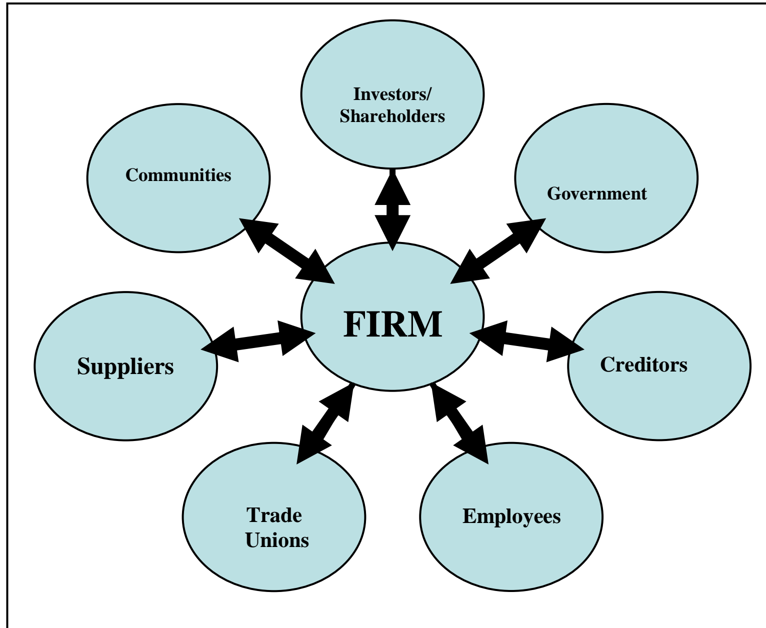

Figure 2.2 : The stakeholder model

Source: Shleifer, A. Vishny, R.A. "Survey on Corporate Governance", cited in: A. Osman Gürbüz, Yakup Ergincan, Kurumsal Yönetim:Türkiye'deki Durumu ve Geliştirilmesine Yönelik Öneriler (2004), p 11.

Groups of "insiders" include family and industry interests, as well as banks and holding companies. Contrary to the outsider model, corporations can also play a key role in corporate governance, because they can have shares in other corporations and hence a long-term relation with that corporation. Because of the better communication flow between "insiders", they are considered to ensure the monitoring of the corporate management. Therefore agency costs are reduced in this model (Nestor & Thomson 2006, p.11).

Nevertheless, contrary to the outsider model, due to the concentration of ownership in the hands of a family, the state, banks, other industrial firms or a few shareholders; block holders (controlling shareholder) control the company and at the same time monitor the management. A conflict of interest between dominant shareholders and minority shareholders is therefore possible and is referred to as the "expropriation problem" by the means of pyramidal ownership structures, multiple classes of shares and/ or cross-

shareholdings (Barker 2006; Oman et al. 2006, p.44).

Table 1 below shows the concentration of shareholding percentages by countries. Japan has the lowest ownership concentration (4.1 percent), followed by China (5.0 percent), US (15 percent), Netherlands (20 percent) and UK (23.6 percent), while Turkey is among the countries with a high ownership concentration (58.0 percent).

Table 2.1 : Ownership concentration by country

Country	Concentration (%)	Country	Concentration (%)
Japan	4.1	Finland	48.8
China	5.0	Belgium	51.5
US	15.0	Thailand	51.9
Netherlands	20.0	Austria	52.8
UK	23.6	Spain	55.8
Ireland	24.6	Turkey	58.0
Canada	27.5	Italy	59.6
Denmark	37.5	Portugal	60.3
Norway	38.6	Germany	64.6
Malaysia	42.6	France	64.8
India	43.0	Indonesia	67.3
Singapore	44.8	Hong Kong	71.5
Taiwan	45.5	Greece	75.0
Sweden	46.9	Chile	90.0

Source: **Gourevitsch and Shinn (2005), cited in: Peter Gourevitch "Explaining Corporate Governance Systems: Alternative Approaches" in: *The Transnational Politics of Corporate Governance Regulation,* Henk Overbeek, Bastiaan van Apeldoorn and Andreas Nölke (eds.) (2007), p 28.**
***These numbers measure the percentage of firm shares owned by the given number of block shareholders. Thus the larger the number, the more shares are owned.**

The most frequently used indicator for comparing of corporate governance systems is the "Minority Shareholder Protections Index" (MSP Index), because high levels of MSP correlate with shareholder concentration. If minority shareholder rights are protected, which means a higher level of MPS, shareholder diffusion will occur, investment will be higher and capital markets will be deeper (Gourevitch 2007, p.30).

As shown in the Table 2 below, Anglo-American countries with common law have the highest level of MSP and have the least concentrated ownership. Turkey has a low percentage of MSP (23), after Portugal (26) and Italy (24).

Table 2.2 : Minority shareholder protection index**

Country	Information (Disclosure and Audit)	Oversight (Board Independence)	Control Rules (Voting Processes)	Managerial Incentive (Executive Pay)	TOTAL MSP
US	86	100	100	100	97
Singapore	89	71	80	97	84
Canada	83	71	100	78	83
UK	81	60	100	53	74
Hong Kong	85	14	100	81	70
Ireland	69	71	80	59	70
Malaysia	84	36	80	69	67
Chile	35	14	100	66	54
France	64	37	60	47	52
Spain	57	14	80	50	50
Norway	66	29	80	16	48
Sweden	67	36	60	22	46
Finland	60	36	60	16	43
India	50	7	100	0	39
Japan	66	0	80	0	37
Denmark	44	43	40	16	36
Netherlands	57	0	40	47	36
Taiwan	74	7	60	0	35
Belgium	43	32	0	59	34
Germany	44	29	20	41	33
Thailand	78	7	40	6	33
Austria	40	36	40	6	30
Greece	53	14	40	0	27
Portugal	43	0	60	0	26
Italy	69	7	20	0	24
Turkey	51	0	40	0	23
Indonesia	45	0	40	0	21
China	25	0	20	0	11

Source: ***Gourevitsch and Shinn* (2005), cited in: Peter Gourevitch "Explaining Corporate Governance Systems: Alternative Approaches" in: *The Transational Politics of Corporate Governance Regulation,* Henk Overbeek, Bastiaan van Apeldoorn and Andreas Nölke (eds.) (2007), p. 31.**
**** The higher the level of MSP, the more effective management and reassured investors.**

Finally, the capital markets of countries using the insider model are relatively less developed and less liquid with a lower market capitalization[11] compared to Anglo-American countries (see Table 2.3 below).

[11] Market capitalization is a measurement of corporate or economic size equal to the share price times the number of shares outstanding of a public company.

Table 2.3 : Comparative financial indicators

Countries *Indicators* *2006*	US	UK	Japan	China	Spain	France	Germ.	Italy	Turkey
Listed domestic companies, total	5,133	2,913	3,362	1,440	3,339	717	656	284	314
Market cap. of listed companies (% of GDP)	148	160	108	92	108	108	57	55	40
Market cap. of listed companies (current billion US$)	19,425	3,794	4,726	2,426	1,323	2,428	1,637	1,026	162
Stocks traded, total value (% of GDP)	253	178	143	62	158	111	86	74	57
Stocks traded, (current billion US$)	33,267	4,242	6,252	1,635	1,930	2,504	2.486	1,366	227

Source: World Bank, database (2006)

For each type of ownership structure and its represented model, a certain type of remedies and disciplinary mechanisms are suggested for the different problems arising for each specific pattern. Dispersed shareholder ownership as a feature of the outsider model implies a weak shareholder's voice when important decisions are taken by the managers. Allowing voting by mail or by electronic means, and the provision of proxy voting are effective tools to deal with this problem. For the problem of unaccountable boards and CEO carrying out visionary projects such as massive acquisition programs, the standard remedies suggested for the outsider model are: increasing the autonomy of the board from the CEO, appointment of independent and non-executive directors, increasing director's liability, establishing committees consisting of independent directors for the remuneration, audit and nomination of the board members, accelerating hostile takeovers and introducing a market for corporate control. On the other hand, the insider model faces the problem of the blockholding shareholders using their power at the expense of minority shareholders. For this the OECD principles of Corporate Governance (2004) recommend the appointment of independent directors. One-share-one-vote rules or voting right ceilings together with minority shareholder approval for the removing of directors are the possible disciplinary devices (Becht & Mayer 2003, p.260; Becht 2003).

Table 2.4 below provides a comparison of the basic differences between the "insider model" and the "outsider model" of corporate governance:

Table 2.4 : Comparative table between the two models

	Shareholder (Outsider) Model	**Stakeholder (Insider) Model**
Characterized By	**Market-centered system (equity based)**	Bank-led system
Objective of the Company	Maximize shareholder value, and corporate profitability, considering the interests of shareholders	Long term value creation, stability and growth, considering interests of all the stakeholders
Capital Markets	Large, well developed and liquid	Relatively smaller and less liquid
Number of firms which are publicly traded	High	Small proportion of the total number of firms are listed
Ownership structure	Widely held, dominated by portfolio oriented institutional investors, with less than 3 percent share	Concentrated ownership in a few hands (family, state, bank or other industrial companies), usually cross-ownership, pyramidal structure is prevalent
Owner's Perspective	Large firms are owned by institutional investors with little attachment in the long-term future of the firm.	Owners of large firms have a long-term relationship with the managers
Dominant Agency problem	Management vs. Shareholders	Minority shareholders vs. Controlling Shareholders
Shareholder rights	Strong	Weak
Employee protection	Low	High
Role of the Banks	In US banks do not hold shares in industrial concerns. In UK, banks do not hold shares in industrial companies as well, however institutional investors such as pension funds and insurance companies dominate holdings in industrial companies.	Traditionally, banks are involved in management and development of industrial companies as not only creditors but also as shareholders
Composition of Board	Non-executive directors elected by shareholders comprise the majority of the board.	Blockholders/insiders monitor the management directly and closely, worker participation in the boards (two tiered continental European board model where a supervisory board consists solely of non-executives, mainly employee representatives and shareholders and a lower level management board consists of full-time managing directors)

2.4.2.1 Germanic model

Germanic model is a bank-based, as the banks play a key role in this type of corporate governance model. The banks have long-term stakes in the corporations and representatives in the corporate board (Mazullo 2008, p.11).[12] Main reason for this is that in Germany, a universal banking system is prevalent, where banks can provide multiple services and

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[12] E.g. in 1990, Deutsche Bank AG, Dresdner Bank AG and Commerzbank AG, the three largest banks in Germany, held seats on the supervisory boards of 85 out of the 100 largest German corporations.

dominate the financial market. Moreover, they also play a key role by being also lender, issuer of equity, depository and voting agency in the annual general meetings of the companies.

Contrary to the Anglo-American model which has a “single board” system, the Germanic model has a “two-tiered board” structure, used in Germany and also in Austria, the Netherlands, Switzerland and France: supervisory board (*Aufsichtsrat*) and management board (*Vorstand*). The management board is responsible for daily management of the corporation and composed of “insiders”, while the supervisory board consists of directors elected by shareholders and representatives of employees and unions as well as the banks, similar to the “outsiders” in Anglo-American boards. Supervisory board members are responsible for appointing and dismissing the management board, as well as approving major decisions such as dividend proposals, company’s accounts and major capital investment decisions, including decisions on acquisitions and plant closings (Gugler et al. 2006, p.34).

Besides, the Germanic model has the following further features:

a. Co-deterministic approach providing that in corporations with 2,000 or more employees, representatives of the shareholders and employees must have (half of the total number) equal seats;
b. Interests of employees are seen as important as the ones of shareholders;
c. Cross-shareholdings between companies are common;
d. Stock and bond markets are not well developed and non-financial enterprises such as other corporations are an important group of shareholders;
e. Shareholder rights such as the right of proposal or counter-proposal are common.

Within the last decade, a number of reforms has been introduced in Germany including the modernization of the corporate law in 1998, the Takeover law in 2001 and finally the introduction of the German Corporate Governance Code in 2002 (Noack & Zetzche 2004), with the aim to make Germany’s corporate governance rules transparent for both national and international investors, thus strengthening confidence in the management of German corporations.

2.4.2.2 Family/State based model

The Family based model mainly prevails in East Asia and many emerging and developing countries including Turkey. This model also dominates the Latin American countries such as Mexico, Brazil, Argentina, and can be found in some EU countries such as Italy, Spain and France (to a certain extent).

Family business is defined by Suehiro (1993) as: "*A form of enterprise in which both management and owne rship are controlled by a family kinship group, either nuclear or extended, and the fruits that which remain inside that group, being distributed in some way among its members*" (in Khan 2001, p.9).

This system can be characterized by:

a. Relationship-based institutions;
b. Concentration of ownership (pyramid structures and cross-holdings);
c. Dominant shareholdings by families;
d. Conflict of interest between dominant shareholders, managers and minority shareholders;
e. Multiple voting rights;
f. Lack of transparency (Millar et al. 2006, p.339).

Founding families and their affiliates usually control the network of listed and non-listed companies. Family-owned business usually lacks a separation of ownership and management as well as a separation of directors and managers so that a real system of checks and balances does not exist within the corporation. As the family as a block holder controls the management and the board and can dismiss board members or managers, the concept of independent directors can therefore not be applied efficiently (Jaffer & Sohail 2007, p.4). Further disadvantages are the high risk of expropriation, related-party transactions on non-commercial terms and the possible transfer of the company's assets to other companies owned by the family and finally the succession problematic (Millar et al. 2006, p.339)

However, the family-owned system is considered to also have some advantages, such as a stable ownership, a long-term commitment of the shareholders, high degree of re-investment of earnings, firm-specific investments by stakeholders contributing to high rates of growth and lower agency costs (Nestor & Thomson 2006, p.16).

2.4.2.3 Japan based model

Japan has a bank-centered system and stakeholder oriented corporate governance framework and resembles the Germanic model, nevertheless there are also some unique elements different than both the Germanic and the Anglo-American model.

In the Japanese model, interests of stakeholders such as employees and clients tend to come before the interests of shareholders. Key characteristics of the Japanese system are:

a. Widely-held ownership;
b. Cross-shareholdings;
c. A dominant role of banks;
d. Large financial networks;
e. Long-term commitments;
f. Director linkages and
g. Inter-firm trading (Dietl 1998, p.1).

Unlike the Anglo-American model, several companies are linked together though interlocking directorships. These intertwined groups of firms are called *keiretsu* (Gugler et al. 2006, p.27). A main bank as well as several other banks or financial institutions hold shares of the group companies, creating a network of financial and industrial firms. The main bank and/or other financial institutions also have representatives on the supervisory board of these companies and the main bank is usually the major shareholder in the corporation. Thus, Japanese *keiretsu* provides a multidirectional control and the average board contains up to 50 members. On contrary to the Anglo-American model, non-affiliated shareholders are weak to have an effect on board and company decisions and there are almost no “outsiders” in the board. Governmental ministries traditionally have a strong regulatory control in Japan, thus the main bank, the *keiretsu*, the management and the government has a stronger relationship which characterizes the Japanese model. Unlike the

Germanic system, Japan has a single board of directors dominated by managers. Consequently, there is a tendency of conflict between shareholders and management, and board members can hardly protect shareholder rights (Mazullo & Geoffrey 2008, pp.6-7).

2.4.3 Is There a Convergence in Corporate Governance Models?

There is still a debate on the two main models of corporate governance whether one of them prevail the other or if there will be a convergence in the future. Most of the debates are focused on as *Albert* (1993) and *Hall* and *Soskice* (2001) discussed in their studies (in Apeldoorn & Horn 2007, p.78) whether the changes and developments of EU regulations in the scope of corporate law and corporate governance implies a convergence of Rhenish capitalism on the Anglo-Saxon model, or as *Cernat* (2004) and *Rebérioux* (2002) discussed in their studies whether it is true that what we are witnessing is a new, "*hybrid*" form of European corporate governance (in Apeldoorn & Horn 2007, p.78). Due to the globalization in general and recent corporate scandals and the pressures coming from the institutional domestic and foreign investors in particular, convergence seems to be a reaction. Nevertheless, both the two models have weaknesses and strengths and according to the institutional and legal structure of the regions or national countries and nature of their business, each model has its own precedence over the other together with its unique governance mechanisms and tools. On the other hand, it is important to say that convergence must not be perceived as it means a victory of one system over another. It must not be perceived as unification of the national legislation, either. What is important is the possibility and flexibility of the firms to move from one regime to another as their needs and constituencies change (Nestor & Thomson 2006, p.29). Convergence means also the positive reception of a common understanding regarding policy direction (Derman 2004, p.134).

There are some commentators and researchers who predict a shift of European and Asian countries towards the Anglo-American corporate governance model, due to the stronger capital markets, higher disclosure and efficient mode of finance and governance (Hansmann and Kraakerman 2001; McCahery et al 2002; Hamilton and Quinlan 2005, p.30).

Nevertheless, it can be stated that there is a tendency of convergence in many aspects mainly focusing on increasing the shareholder rights and transparency due to the globalization of the capital and product markets. Preliminary data and anecdotal evidence also suggests that European corporate governance has been shifting towards the outsider model during the last decade. Some significant reforms and changes are also examined in national level such as Germany, France and Sweden. The amendment of German corporate law in 1998 included the protection of shareholder value as a corporate objective (Barker 2006). Germany also took important steps to facilitate takeovers, and eliminated voting right restrictions and some cross-shareholdings involving banks. In Italy, *Draghi* Law of 1997 increased the shareholder rights. In Spain and France, the privatization process has accelerated the decline of the state control. The reform of the French company law based on the *Marini* Report of 1997 gave firms more liberties concerning the way they shape their financial structures. Sweden which is an example of traditionally family-based ownership system started to contain some elements of the outsider model besides the existing insider model through evolution over time. The Swedish stock market is now more supported by a market-oriented legal framework and thanks to intermediary investment companies and foreign investors monitoring actively the company management. In Sweden dual-class shares and cross-shareholdings have also been eliminated in most of the firms. Moreover, as more companies outside of the US are listed in NYSE, and thus being subject to US securities rules and accounting rules, they have to adopt their systems in accordance with the US system (Nestor & Thomson 2006, pp.15-29; Becht & Mayer 2003, p.260).

The globally accepted OECD corporate governance principles also contribute to more convergence since providing a “common language” for both developed and developing countries.

Finally, the last convergence area in corporate governance concerns the International Financial Reporting Standards (IFRS). IFRS have already been enacted by the EU and oblige all EU companies listed on EU exchanges to prepare their financial reports under the principle-based IFRS as of 2005. The EU has made considerable progress in harmonizing accounting, auditing and corporate governance within the context of EC’s Financial Services Action Plan (FSAP). Some non-European countries also converge their national

standards partially or completely with IFRS such as Australia, Hong Kong, Israel, Canada, New Zealand and Turkey (Larson & Street 2006; Derman 2004 p.75).

However, US apply its own US GAAP which is grounded on rules-based approach and has chosen not to recognize IFRS or other international standards equivalent to its own standards in US listing requirements. Nevertheless, International Accounting Standards Board (IASB) of the EU and Financial Accounting Standards Board (FASB) of US, as the enforcement bodies of these financial reporting standards, announced a Memorandum of Understanding (2002) –the Norwalk Agreement- pledging their best efforts to: *"(a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained*". Both boards agreed to prioritize removing a variety of differences between US GAAP and IFRS in both the short term and the long term and to coordinate future work programs and joint projects. Non-domestic companies listed on US exchanges will not have to be required to reconcile IFRS to US GAAP and for this a roadmap is determined establishing a timetable of eliminating the reconciliation by 2009 at the latest. This will mitigate the burden of the EU listed companies in US stock exchanges which are required to prepare financial statements under multiple accounting regimes. In order to allow companies time to translate and implement IFRS, the IASB decided in July 2006 that no new major IFRS will be effective until January 1, 2009. Still, the IASB continues to work jointly with FASB on the development of new standards in some key areas. Until today, FASB has issued several standards that eliminate differences with IFRS and amended some of its standards to be more in line with IFRS while the IASB has also modified several of its standards conform with US (Dewig & Russel 2007, pp.139-144; Larson & Street 2006).

2.5 INTERNATIONAL CORPORATE GOVERNANCE STANDARDS

There is no single universal one-size-fits-all-type of code that suits every company and country. Every country sets up its own corporate governance principles, according to its own needs, economic, legal, social, cultural and institutional structure and general country-specific factors and conditions. However, international organizations and networks such as the Organisation for Economic Co-operation and Development (OECD), the International

Corporate Governance Network (ICGN), the International Chamber of Commerce (ICC), the Global Corporate Governance Forum (GCGF) and the Commonwealth Association for Corporate Governance have developed some international guidelines and have organized roundtable meetings to stress the importance of corporate governance. Other international organizations such as IMF and World Bank have also put corporate governance issues on their agendas and include it in their aid programs for developing countries. Among these international institutions, OECD is probably the most important and world-widely accepted one, working actively on corporate governance issues. In 1999, OECD issued its non-binding Principles of Corporate Governance which identify some common elements that underlie good corporate governance. These principles are recognized by policy makers, investors, corporations and stakeholders worldwide in both OECD and non-OECD countries as an international benchmark. Due to the new challenges and recent developments, OECD revised its Principles in April 2004.

The Principles mainly focus on financial and non-financial publicly traded companies; however they can also be applied as a useful tool to a certain extent to non-traded, as well as to private and state-owned companies.

The OECD Corporate Governance Principles treat the following six areas:

a. Ensuring of the basis for an effective corporate governance framework;
b. The Rights of shareholders and key ownership functions;
c. The equitable treatment of shareholders;
d. The role of stakeholders;
e. Disclosure and transparency and
f. The responsibilities of the board.

In the revised version of oecd principles in 2004, a new chapter was added regarding the structure and quality of the regulatory framework, underlining the importance of effective regulation and enforcement. Within this regard, dispute resolution is an essential element for civil enforcement. Thus, the oecd also has a work program on dispute resolution area and continuously follows the developments of its members to help them to share information about changes in the area of corporate governance and company law.

To effectively adopt the OECD Principles as a reference in their reform initiatives in developing and transition countries, OECD and World Bank have signed a Memorandum of Understanding.

In view of the specific issues to the corporate governance of state-owned enterprises (SOEs), OECD has also developed the OECD Guidelines on Corporate Governance of State-Owned Enterprises in April 2005 as a complementary and fully compatible instrument to the OECD Corporate Governance Principles which serve as the first international benchmark to assist the states, as owners of these companies, in adopting, improving and evaluating the corporate governance regimes of SOEs.

OECD has also conducted regional corporate governance roundtables on corporate governance for non-listed companies (NLC) and within this development, The Global Network for Corporate Governance of Non-Listed Companies was launched at the International Experts Meeting on Corporate Governance of NLC held in Istanbul in April 2005, aiming to gather the policy-makers and practitioners to better understand the challenges for non-listed companies. The Network decided to develop a checklist/reference document that would raise awareness of the policymakers on where they can facilitate lowering burdens for these companies which will result in better corporate governance and business performance.

Besides these, OECD set up The Forum for Asian Insolvency Reform (FAIR) in co-operation with the Asia-Pacific Economic Co-operation forum (APEC), the Asian Development Bank, and the World Bank, with assistance from the governments of Japan and Australia to keep the focus on insolvency in the Asian Region as a top policy priority and identify important areas for future reforms.

Finally, since disclosure and accounting are the two key words of corporate governance, OECD also focused specifically these areas and established two regional bodies: the

International Regional Federation of Accountants and Auditors in Eurasia (IRFAA) and the South Eastern European Partnership on Accountancy Development (SEEPAD)[13].

With regard to accounting standards, the International Organization of Securities Commissions (IOSCO) has launched its own project in collaboration with the International Accounting Standards Committee (IAS) to set up international accounting standards to be used in cross-boarder listing (Licht 2006, pp.207-209).

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[13] The objective of SEEPAD are to create sound corporate governance, financial disclosure and accountancy regimes; develop and strengthen the accounting and audit profession in SEE through sustainable self-regulatory associations; lower trade and investment barriers by harmonizing accounting and audit practices in the region; and integrate the SEE profession into the European Union and international community. See for further information www.seepad.org.

3. CORPORATE GOVERNANCE IN EUROPE

3.1 EU'S INITIATIVES, DEVELOPMENTS OF POLICIES AND REGULATORY REFORMS REGARDING CORPORATE GOVERNANCE AT SUPRANATIONAL LEVEL

The EU's legal perspective on corporate governance is built on the social model of corporate governance. The social policy determined in the Lisbon Agenda leads to a more stakeholder friendly corporate governance of EU. As we will discuss in more detail in the following sections, the European Commission is the key actor at EU level taking many initiatives in this area. The working paper of the Internal Market Directorate General, dated November 2003 indicates that the majority of the European companies agree that there is no need for a corporate governance code at EU level. In this paper, EC stated that it believes that a "European Corporate Governance Code would not add value but only constitutes an additional level between international principles and national codes" (p.7). On the other hand, the Commission also believes that solely a self-regulatory market approach, based on non-binding recommendations, is also not enough to assure sound corporate governance. For this reason, the European Union adopts a common approach covering a few essential rules and tries to ensure adequate coordination of national corporate governance codes (Lawlex 2003). In this Chapter, the corporate governance action plans, initiatives and reforms at the supranational level will be discussed to reflect the approach of European Community on corporate governance.

3.1.1 EU's Objectives and Strategies on Internal Market

The creation of a "single common market" with free movement of goods, persons, services and capital was one of the main objectives of the Treaty of Rome in 1957. The Single European Act of 1987 introduced the term "internal market" into the original expression of "common market" which is considered to represent a more fully integrated evolution of the common market (Gielen et al. 2007).

The EC has initiated the "Europe 1992" program to accelerate its market integration efforts, because of the considerable slowdown of EU integration process through the early 1980s

albeit the establishment of the customs union in 1968. This program has resulted in the adoption of many internal market Directives, however many measures, including company law have not been adopted and additionally EU member countries have experienced many transposition and enforcement problems. Hence, the EC issued its *Communication on the Impact and Effectiveness of the Single Market* in 1996 to emphasize the need for concerted actions in the areas of company law and financial services and since then the EU has launched a number of strategies and action plans for the completion of the Internal Market.

Following this, in 1997, the *Action Plan for the Single Market* was announced in the conclusions of the Dublin European Council, stressing the need to:

(a) promote greater competitiveness of European capital markets as a means for attracting trade and investment,

(b) make European companies more attractive in international capital markets.

In order to achieve these abovementioned goals, harmonization of accounting standards was prerequisite. In the Action Plan, the EU set out in detail the priority measures to be taken to improve the functioning of the single market and four strategic objectives are determined as the following:

a. To make the rules of the single market more effective ,
b. To deal with key market distortions,
c. To remove sectoral obstacles to market integration,
d. To deliver a single market for the benefit of all citizens.

Each of these strategic objectives was accompanied by a number of operational objectives and those relevant to company law, including corporate governance, accounting and audit were the following:

a. The Financial Services Action Plan (1999),
b. The Lisbon Strategy (2000),
c. The *Lamfalussy* Report (2001),
d. The *Winter* Report (2002),

e. The Company Law Action Plan (2003) and

f. The Internal Market - Priorities 2003–2006 (2002).

The EC mainly addressed corporate governance issues through its company law and financial services policies.

3.1.2 Harmonizing European Company Law and Corporate Governance as a sub-field

Until recently, corporate governance was not seen as a separate and interdisciplinary concept by the EC and it was dealt with only at national level. Corporate governance was perceived as a policy issue relating to the corporate law and the securities law. Within time, there is a shift of the EU's approach from harmonization of company law and corporate governance as a sub-field of company law through public intervention to market regulated and market-based corporate governance system to achieve financial efficiency and competitiveness (Apeldoorn & Horn 2007, pp. 83-92).

Harmonization was achieved through a series of EU Company Law Directives. The first harmonization Directive regarding company law was adopted in 1968 and until 1989 nine directives and one regulation were passed. Among them, the Takeover Directive has a long and interesting legislation history, started in the 1970s with the EC's harmonization objective. In 1989, the EC published its first draft, however several member states such as Sweden and Germany objected the draft saying that implementation of this Directive would put them at comparative disadvantage due to their corporate governance regulations. Following the disapproval of this proposal by the European Parliament in 2001, a High Level Group of Company Law Experts (HLG) have been established from academia and business to set up recommendations and thus the EU Takeover Directive (Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids) could finally come into force on May 20, 2004 to be transposed into national law by all member states by May 20, 2006. The so-called Directive includes mandatory rules in the areas of corporate governance of disclosure and board transparency as well as presents flexibility to member states by providing them an optional choice to decide whether some of the other related governance provisions such as abolishing multiple voting rights and

neutrality of the board should be implemented when transposing into their national law (Apeldoorn & Horn 2007, pp. 83-92).

Furthermore, in the 1985 White Paper, the EC argued that "*the regulatory strategy totally based on harmonization would be over-regulatory; would take a long time to implement, would be inflexible and could shifle innovation*", thus harmonization should rather be substituted by mutual recognition of national regulations and company laws, based on competition as a mechanism for convergence rather then centralized top-down regulation (Apeldoorn & Horn 2007, pp. 83-92).

As *Rhodos* and *Van Apeldoorn* argue:

> *One of the reasons for the acknowledgement of subsidiary at Maastricht was the battle waged in the 1980s and early 1990s over attempts to introduce a uniform system of corporate governance. Harmonization had been advocated from various quarters, but in fact the directives regulating European corporate space have either been blocked by national disagreements over surrendering national sovereignty or have been issued in a form that allows a degree of national diversity* (in Apeldoorn & Horn 2007,p.85).

To sum up, EC's approach has become to eliminate obstacles for free movement of capitals and companies rather than advocating positive harmonization. Corporate control used to be located in company law, however now it has become the core point of capital and financial law, where capital/financial law and corporate governance/company law overlaps each other.

As the EC's approach shifted from harmonization to regulatory competition, mutual recognition of corporate governance models and flexibility of choosing models became favorable by the EU. The Court of Justice grants companies the freedom to choose their governance model by moving their place of incorporation. Another reform has been made by Italy and France in their corporate laws allowing companies to freely choose either a traditional (Italian or French) model or the outsider model like the UK or the Germanic model of corporate governance (Becht 2003). Another form is the establishment of the *Societas Europaea* (SE), the "European Public Company" which was adopted in 2001[14]. A statute is adopted for SE to create a single legislative framework which will allow companies incorporated in different member states to merge or form a joint subsidiary or a holding company, while avoiding the legal and practical constraints arising from the

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[14] See also The EU Single Market, http://ec.europa.eu/internal_market/company/se/index_en.htm

existence of many different legal systems. An SE can be registered in any member state of the EU in which it has its head office provided that the registration is published in the Official Journal of the European Union and the registration can be easily transferred to another member state. Moreover the governance of an SE can be designed according to many different alternatives (Becht 2003).

3.1.3 Financial Services Action Plan

Knowing that the financial integration is an integral part of the formation of the single market and financial sector is the motor for the economic growth and employment, the EU has accelerated its actions and has published the Financial Services Action Plan (FSAP) in May 1999, aiming to remove the obstacles to an integrated financial market. The EC believed that in order to be competitive and market-oriented, formation of a fully integrated capital market is prerequisite. FSAP, with 42 measures, was scheduled to be completed by the end of 2005, however almost all of these measures have been adopted by the end of 2004. The aim was to harmonize the member states' rules on securities, banking, insurance, mortgages, pensions and all other forms of financial transaction (Apeldoorn & Horn 2007, p.88).

FSAP has also give impetus to the attempt to create a more market-driven corporate governance regime. Corporate governance issues started to be embedded more within financial market integration by a comprehensive financial plan with an objective of neo-liberal competitiveness, than to be regulated in mere company law. Similarly, *Alexander Schaub (2004)*, former Director General of the EC's Internal Market Directorate, states that:

> *The growing importance of corporate governance on the political agenda is not just a response to the recent wave of scandals in the US and in Europe. First and foremost it is a key component of a strategy to boost business' competitiveness and to foster efficiency in a modern economy* (in Apeldoorn & Horn 2007, p.89).

The Securities expert group mentioned in the final report of FSAP published in May 2004 that since corporate governance codes of member countries of the EU show a high level of convergence, there is not any need for a single EU code, yet common guidelines should be adopted at EU level, considering different methods and organizational models, to promote a financial market approach to corporate governance. The Securities Expert Group suggested that the guidelines must be flexible enough to facilitate acceptance and implementation by

member countries and might include the issues such as a definition of corporate governance, internal (annual corporate governance statement, information about a company's governance structure, institutional investor as a shareholder participation in annual general meetings, electronic voting, cross-boarder voting, responsibilities of the board, audit and other committees) and external (auditors, financial analysts, investment banks) elements of corporate governance, as well as encouraging greater compliance with the national codes (development of a corporate governance index). This EU approach already shows the shift from its historically implemented social model to a more market-based approach, in addition to the covering of shareholder model tools and mechanisms.

The European Community has also indicated that in order to achieve the goals of the FSAP, there are some general conditions to be provided and one of the condition is the convergence of the codes of member states for the efficient operation of the European financial market. As it's mentioned in FSAP, the Community determined its initiative in this area in 2001 as reviewing national codes of corporate governance of different member states in order to identify any barriers which could hinder the development of a single financial market. The related full comparative study of Weil, Gotshal & Manges LLP titled "Comparative Study of the Corporate Governance Codes relevant to the European Union and its Member States" (March 2002), prepared for the EC, concluded that rather than devoting the efforts to develop a European corporate governance code, EC should focus on the reduction of legal barriers for the shareholders to engage in cross-border voting and accession of corporate information (p.7).

The European Council sees the FSAP as an integral part of its 'Lisbon Agenda' which will be discussed in detail in the following Section.

3.1.4 Lisbon Agenda and the EU's Social Model

In face of the new challenges such as globalization, technological development and ageing, the EU Council has launched its Lisbon Strategy in March 2000 to start a new economic and social reform process. In the Lisbon Agenda the objective was indicated as "*to make the EU the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment by 2010*". Hence, economic competitiveness, social inclusion

and environmental protection became the three pillars of the Lisbon Agenda. Accordingly, economic growth, employment and social policy will be aimed to be implemented and provided at the same time. As Fannon mentioned, the Lisbon Agenda aims to make social and economic fields complement each other. "Competitiveness" is the cornerstone of the Lisbon Agenda, while EU pursues its social model of corporate governance.

The Agenda focuses on a variety of issues, including full integration of financial services and capital markets, calling for lowering regulatory costs and removing barriers to cross-border trade. It has been reviewed by a High Level Group in 2004 in the *Kok* Report. In the *Kok* Report, it has been emphasized that regarding the Lisbon Agenda, due to the overbroad agenda, poor co-ordination, conflicting and ambiguous priorities, together with the lack of political will by the member states, a lack of progress has been confronted on the objectives of the agenda. Therefore so-called report formulates policy recommendations in five areas to give new impetus to the process: knowledge society, internal market, improved climate for entrepreneurs, adaptable and inclusive labor market and an environmentally sustainable future. Regarding the internal market, the Report recommended fostering transposition of the legislation on the internal market field, to remove obstacles to free movement of services by end 2005 and to adopt remaining legislation of FSAP (Gielen et al. 2007).

The EC used the *Kok* Report as a basis for its proposal in February 2005 to refocus the Lisbon Agenda on actions that promote sustainable growth and employment in a manner that is fully consistent with the objective of promoting social or environmental objectives. In the mid-term review of the Lisbon strategy in March 2005, this "sustainable growth and jobs" objective of the EU is underlined again for the acceleration of the social and environmental progress of the EU which will then strengthen Europe's economic performance.

The European Social Model of corporate governance is highlighted by the EC in 2004 by the means of the Lisbon Agenda by the following statements:

> *. . . the Lisbon agenda must be owned by all stakeholders at EU, national, regional and local level; Member States, European citizens, parliaments, social partners and civil society and all Community institutions. They should all contribute to construct Europe's future (COM (2005) 24/final, p.12).*
>
> *. . . we need to restore confidence in Europe's ability to create the conditions to meet its objectives. Europe can build on its rich tradition and diversity, its unique social*

> *model and draw from its recent enlargement which makes it the largest single market and biggest trading block in the world (European Commission 2004 in Fannon, p. 443).*

From the abovementioned statements, we can comment that the EC does not discard from its social model, yet seeing it as its competitiveness.

3.1.5 Lamfalussy Report

Integration of European financial market project has been deepened through the creation of a transnational expert group, the so called "Committee of Wise Men on the Regulation of European Securities Markets" in 2001, under the chairmanship of *Alexandre Lamfalussy,* a Belgian banker. Therefore the project was de-politicized, by leaving the reviewing of the project to the technical group (Apeldoorn & Horn 2007, p. 89).

In the *Lamfalussy* Report, the factors slowing down the financial market integration have been examined. Different legal systems with different judicial systems, different tax regimes and cultural barriers are enumerated as obstacles which are distorting the integration of EU financial market. Cultural discrepancies and different attitudes of member states towards corporate governance and investor protection have been underlined as barriers to overcome. The Final Report of The Committee of Wise Man on The Regulation of Securities Markets, Brussels (2001) suggested making a reform on the securities regulation as well.

Alexandre Lamfalussy has initiated a new approach in 2001 -known as *Lamfalussy* Process- for the development of the financial service regulations. Since then it has been used in the law making in the banking and securities sector and it has contributed to the development of a more flexible, efficient and rapid European regulatory framework, providing greater cooperation between national regulatory authorities and greater consistence and convergence in national implementation and enforcement of the legislation. According to this committee-based approach there are four levels: At the first level, the core principles and guidelines for the implementation are set up by the co-decision process of the European

Parliament and the Council of EU. In the second level, technical details are adopted by the EC as implementing measures, in coordination and after a voting procedure by the

competent regulatory committees. At the third level, national supervisory representatives work together as Committees, set up by EC decisions for the coordination of the new regulations and providing advice to the EC. And finally at the last level, the EC enforces the timely and correct transposition of EU legislation into national law.

3.1.6 Winter Report

Besides the above mentioned 'Committee of Wise Men on the Regulation of European Securities Markets', another expert group was set up in 2001 to advise the EC on the modern regulatory framework for company law in EU, including corporate governance. This group was called "The Group of High Level Company Law Experts" also known as *Winter* Group, appointed by *Frits Bolkestein* and chaired by *Jaap Winter*, a specialist on corporate law, corporate governance, corporate litigation and insolvency. Their report on modernization of the regulatory framework for company law in Europe, titled "Report of High Level Group of Company Law Experts On a Modern Regulatory Framework For Company Law in Europe" published in 2002, shortly - the *Winter* Report - is an important step for changing the EU's traditional harmonization approach, aiming at the prevention of regulatory competition and protection of the interests of the member states and third countries at country level and interests of shareholders and stakeholders (mainly creditors) at the company level to a new approach where more market-based regulatory mechanisms are used. The *Winter* Report focuses on not only on how to modernize the company law but also on how to improve the corporate governance practices and standards in EU. This expert group has also played a great role on the development of the EU Takeover Directive (Apeldoorn & Horn 2007, p.90).

In the *Winter* Report, corporate governance issues are examined in detail and specifically with many recommendations on how the EU should co-ordinate the efforts of the member states on this field in order to improve corporate governance in Europe. Corporate governance is defined in the report as a system, having its foundations partly in company law and partly in wider laws and practices and market structures (p.44). Before summarizing the important recommendations of the Group on specific elements of corporate governance, it should be stated, that the general orientation of the report was favorable to "shareholder value" as clearly emphasized in these lines:

...In a proper system of corporate governance, shareholders should have effective means to actively exercise influence over the company. As we emphasized in our Consultative Document, shareholders are the residual claimholders (they only receive payment once all creditors have been satisfied) and they are entitled to reap the benefits if the company prospers and are the first to suffer if it does not. Shareholders need to be able to ensure that management pursues and remains accountable to their interests. Shareholders focus on wealth creation and are therefore, in the Group's view very suited to act as "watchdog" not only on their own behalf, but also, in normal circumstances, on behalf of other stakeholders (Winter et al. 2002, p.47).

Important issues and some important recommendations regarding corporate governance mentioned in the Winter Report (2002) are summarized in the following table:

Table 3.1 : Winter report recommendations

THEMES	RECOMMENDATIONS
Disclosure	- Listed companies should be required to include in their annual report as well as company's website a statement covering the key elements of the corporate governance rules and practices they apply. The principles and key items to be disclosed should be set up in a framework Directive. - All annual meeting materials and proxy forms should be contained in the company's website. - Listed companies should disclose in their corporate governance statements how and under what conditions shareholders can submit proposals and ask questions in the shareholders meeting
Shareholders	-Electronic participation in the annual meetings should be permitted. - A European framework rule should be adopted regarding the right of minority shareholders to apply to a court to order a special investigation. - Institutional investors should disclose their investment policy and their policy with respect to the exercise of voting rights in companies in which they invest.
The Board	-There must be a permission of freely choosing any type of board structure (one or two tier). - Prohibition of remuneration in shares and share options is not necessary, but there should be some rules regulating. - Collective responsibility of the board must cover all statements on the company's financial position, including non-financial data. - Misleading disclosure by directors should be properly sanctioned and these sanctions should be defined by Member States. The disqualification of a person from serving as a director of companies across the EU could be an alternative sanction. - A European wrongful trading rule - the personal accountability of directors in case of a company's failure -should be adopted to enhance creditors' confidence and their willingness to do business with companies. - Independent directors should sit on nomination committees. - The principle of accounting for the cost of share incentive schemes be recognized in a European framework rule.
Audit	The Commission should issue a recommendation to member states to have rules ensuring that the nomination and remuneration of directors and the audit must be decided upon by non-executive or supervisory directors who are in the majority independent. This recommendation should include standards for what is considered to be independent as well.
Corporate Governance Regulation in the EU	-The EU should co-ordinate the efforts of Member States to facilitate convergence, including with respect to enforcement. -Member States should be required to participate in the co-ordination, but both the process and its results should be voluntary and non-binding.

Source: Winter Report (2002)

Moreover, the *Winter* Report presented many recommendations on the designation of the modern European Company Law framework. It has been stated that rather than the EU's

classical harmonization approach, which is based on coordination of safeguards for the protection of the shareholders and stakeholders, a more flexible approach should be embraced, meeting the needs of the company for the efficiency and the competitiveness of the business industry. Elimination of the obstacles for the cross-boarder activities should be on the EU's top agenda. Additionally, rather than bringing fix rules on the structure and organization of the company and board members at the EU level, it would be better to give the member states the freedom of choice. Also, according to the Report, once the EU company law is harmonized through Directives, it would be too difficult to modify the Directive and the underlying approach afterwards. According to the *Winter* Group, Directives are seen even more inflexible than primary legislation in practice. Thus, the Report suggests that if the use of Directives is necessary, they should at least be principle-based, set the general rules and principles and not be in detail. The detailed rules should be left to the secondary legislation. Secondary legislation and mechanisms are best used in the corporate governance area. The EU should consider a broader use of alternatives to primary legislation such as secondary legislation (can be amended easier) or best practices developed by the coordination of market participants and government through the "comply or explain" approach or model laws which are used voluntarily (Winter et al. 2002, pp.29-32).

3.1.7 Modernizing Company Law and Enhancing Corporate Governance Action Plan

The EU needed to modernize the regulatory framework of company law and corporate governance due to the need arising from the impact of corporate crises, the development of communication technologies, especially the internet, the integration of European capital markets, the increasing trend of cross-border operations in the Internal Market of EU and the impact of enlargement policies of EU. Good company law and corporate governance means more investment, greater growth, more jobs and sustainable development and greater competitiveness which are already the key words of EU's Lisbon Agenda. Consequently, for strengthening shareholders' rights, reinforcing the protection for stakeholders (defined as employees, creditors and the other parties with which companies deal) and enhancing the efficiency and competitiveness of the European business, the EC has disclosed its 2003 Action Plan for "Modernizing Company Law and Enhancing Corporate Governance in the European Union- A Plan to Move Forward"'- also known as

Company Law Action Plan (CLAP) as a response to the *Winter* Report[15] presented on November 4, 2002 which underlines the need for immediate action on improving of the EU framework for corporate governance. The CLAP actually complements the FSAP. The EC aimed to encourage the convergence process of national corporate governance approaches and practices through a mixture of legislative and non-legislative measures for the short term (2003-2005), medium-term (2006-2008) and long-term (2009 onwards), providing a dynamic and flexible framework for company law and corporate governance in Europe. The Competitiveness Council invited the EC (September 30, 2002) to organize a debate on this report and to develop an Action Plan for Company Law and Corporate Governance in co-ordination with member states. The European Council then has confirmed the need for adoption of the Action Plan by the EC. The EC has presented its Action Plan on May 21, 2003 (Bolkestein 2007).

According to the EU Press Release on May 21, 2003) the CLAP is based on a comprehensive set of proposals, grouped under six important chapters:

a. Corporate governance,
b. Capital maintenance and alteration,
c. Groups and pyramids,
d. Corporate restructuring and mobility,
e. Other matters (the European Private Company, cooperatives and other forms of enterprises).

The CLAP follows most of the recommendations of the *Winter* Group, however there are also some different proposals of the EC distinguished from the recommendations stated in *Winter* Report. For instance the *Winter* Group recommended that independent directors should have a seat on the nomination committees, however the Action Plan recommended executive directors to be placed in the so-called committee, because EC believes that the members of the nomination committee need to know the company from the inside.

[15] For details see 3.1.6 Winter Report

In the field of *capital maintenance*, the CLAP contemplates a short-term simplification of the relevant Company Law Directive on the formation of public limited liability companies and the maintenance and alteration of their capital. The proposals include:

a. a partial relaxation of certain rules, including those concerning contributions in kind, acquisition of own shares or limitation/withdrawal of preemption rights;

b. an introduction of **“squeeze-out rights”** and **“sell-out rights”** going beyond the proposed Directive on Takeover Bids (which offers those rights only to listed companies and only in the case of a takeover bid).

In the field of *Groups and Pyramids,* the CLAP proposes to introduce expanded financial and non-financial disclosure obligations for groups where the parent company is not listed *(short term).* The EC is also considering the prohibition of stock exchange listings for abusive pyramids, which are defined as chains of holding companies with the ultimate control based on a small total investment.

In the field of *Corporate Restructuring and Mobility,* new proposals are planned for company law directives:

a. For facilitating cross-border mergers in cases where there is no reciprocal national legislation allowing a merger;
b. For transfers of a company’s center of activity and/or registered office, which is currently impossible or at least conditional on complex legal arrangements *(short term).*

Regarding the CLAP, the urgent and short term initiatives of the EC on Corporate Governance are as follows:

a. The introduction of an annual corporate governance statement for listed companies covering the key elements of their corporate governance structures and practices.

b. Development of a legislative framework in EU level regarding strengthening the shareholders’ rights (such as access to the complete information relevant to general meetings and facilitates the exercise of voting rights by proxy and cross-border voting).

c. A confirmation through a Directive of the collective responsibility of directors for financial statements and for key non-financial statements such as the annual corporate governance statement proposed above.

d. Adoption of a recommendation on Directors' Remuneration. Within this context, member states should have some transparency rules, such as the requirement of detailed disclosure of individual remuneration.

e. Adoption of a recommendation to promote the role of independent non-executive or supervisory directors. Minimum standards on the creation, composition and role of the nomination, remuneration and audit committees should be defined at EU level and enforced by Member States, at least on a "comply or explain" basis.

f. Creation of a European Corporate Governance Forum to work for the coordination and convergence of national codes, and their enforcement.

In the following Sections, we will focus in more detail on the EU's efforts as an active player in the "corporate governance area" under the CLAP in terms of fostering shareholder rights, enhancing disclosure, modernizing the board of directors and coordination of corporate governance efforts through Directives or Recommendations.

3.1.7.1 Enhancing disclosure

Annual corporate governance statement

Directive 78/660/EEC on the annual accounts of certain types of companies has been amended by Directive 2006/46/EC of the European Parliament and of the Council in June 14, 2006. According to the new Directive, listed **c**ompanies whose registered office is located in the EU are obliged to disclose an "annual corporate governance statement" as a separate section of their annual report. The EU has decided the minimum information requirement to be included in the statement as: a reference to which corporate governance codes the company is subject; all the key information about its corporate governance practices; explanation of to what extent the company complies with that code; the web site address where these codes are publicly available; description of the main features of their risk management systems and internal controls in relation to the financial reporting process; a description of shareholders' rights and how they can be exercised; the composition and operation of the boards and its committees.

The new Directive also requires public interest entities such as listed companies, credit institutions and insurance companies to have audit committee, including at least one independent and competent in accounting and/or auditing.

More disclosure on transactions and off-balance arrangements

Directive 2006/46/EC also extends disclosure requirements of listed companies on transactions with all related parties such as family members and companies to unlisted companies. Moreover in the Directive, both listed and non-listed companies are required to disclose all the off-balance arrangements and their financial effect in the accounts. [16]

Disclosure by institutional investors

In CLAP, the EC proposed a mandatory disclosure of institutional investors' investment policies and voting practices with regard to the companies they invest. This initiative is determined as a middle-term target.

Disclosure of financial position and major shareholdings

The Transparency Directive came into force on January 20, 2005 and member states had to transpose into their national law by January 20, 2007. This Directive brings minimum standards for the issuers to either issue quarterly reports or an interim management statement indicating the company's financial position and material events and transactions effecting the financial position. Furthermore, if the size of the shareholdings are exceeding or moving below certain thresholds, the shareholder is required to inform the issuer, and the issuer will inform the market (International Finance Corporation 2008).

[16] Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings.

3.1.7.2 Strengthening shareholders' rights

Access to information

With regard to CLAP, enhancement of the shareholders rights of listed companies across the Member States was a priority. Accordingly the EC proposed a Directive on Shareholders' Rights in January 5, 2006 which was formally adopted in June 2007 to be transposed into member states' legislation by summer 2009. The Directive (Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies), brings the following standards:

a. It ensures that shareholders of the listed companies have timely access to the accurate information before the general meetings to vote at a distance by electronic means (minimum notice period of 21 days for most general meetings, which can be reduced to 14 days where shareholders can vote by electronic means);

b. It abolishes the existing constraints of the member states on the eligibility of proxy holder and the excessive formal requirements for the appointment of the proxy holder;

c. It abolishes share blocking and provides for the replacement of share blocking through a record date system (not more than 30 days).

d. It abolishes all the constraints for the electronic voting and electronic participation to the general meeting.

e. Voting results should be disclosed in the internet.

f. It ensures the shareholders to ask questions and the company to answer them.

g. It requires the member countries to offer to their shareholders any form of participation in the general meeting by electronic means and a mechanism for casting votes, whether before or during the general meeting, without the need to appoint a proxy holder who is physically present at the meeting.

Moreover, Transparency Directive has been amended due to the CLAP proposals on enabling listed companies to use electronic means to inform their shareholders in advance of General Meetings.

Shareholder democracy

In the EU member states there are many practices of multiple voting rights, ownership ceiling and non-voting shares; however shareholders must have a say, proportional to the shares they have in a listed company, because the number of the shares represents how much the investors risk for that company. In the CLAP, the EC decided to conduct an external study about the principle of proportionality between capital and control which is also known as the "one-share-one-vote principle" and the related report was published on 4 June 2007. Finally according to the results of the impact assessment, the EC decided not to take any action at EU level. The study showed that there is no sound link between "one-share-one-vote" principle and the economic performance of the companies. The reason for deciding to take no further actions was also relating to the strong lobbying from large EU corporations and the general fear of the hedge funds (International Finance Corporation 2008).

3.1.7.3 Modernizing board of directors

Directors' remuneration

The EC Recommendation on fostering an appropriate regime for the remuneration of directors of listed companies was adopted in December 14, 2004. According to so-called Recommendation (Commission of the European Union, "Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies" (2004/913/EC), member states are invited to adopt measures for the listed companies to release a statement of their policy on directors' remuneration; to put the remuneration policy on the shareholders' meeting agenda, to disclose of individual director remuneration including share options, loans, advances or guarantees granted to them; to ask for shareholder approval of the remuneration schemes under which directors are paid in shares or share options.

Board composition

The EC has issued a Recommendation, 2005/162/EC, on the role of non-executive or supervisory directors of listed companies and on the committees of the board in February 15, 2005. In the recommendation, it was proposed that boards should include an appropriate

balance of executive and non-executive directors; independent non-executive directors must be included in the nomination, remuneration and audit committees; the role of the chief executive officer and the chairman of the (supervisory) board and requirement for the board members of certain knowledge, judgment and experience and a commitment of their time on their work, especially for the ones who are included in the committees. For instance members of the audit committee should have specific financial and accounting knowledge. Furthermore, some disclosure requirements are also recommended such as, information about board member's other assignments on other companies, competences of individual directors and determination of the directors' independence. In the Recommendation 2005/162/EC, "*a director is considered independent when free from any business, family or other relationship - with the company, its controlling shareholder or the management - which might jeopardize his or her judgment*" (Commission of the EC 2007).

According to the so-called Recommendation, the supervisory role of non-executive or supervisory directors is commonly perceived as crucial in three areas, where the potential for conflict of interest of management is particularly high: nomination of directors, remuneration of directors, and audit. It is therefore recommended to foster the role of non-executive or supervisory directors in these areas and to encourage the creation within the (supervisory) board of committees responsible respectively for nomination, remuneration and audit (2005/162/EC).

Directors' collective responsibility

In the CLAP, one of the EC's aims was to enhance the board's responsibilities. Within this perspective, collective responsibility of the board for the preparation and publishing of the financial and non-financial statements including the "corporate governance statement" mentioned above in Section 3.1.7.1. are regulated in the Directive 2006/46/ EC in June 14, 2006.

3.1.7.4 Audit independence

EU's Eight Company Law Directive on statutory auditors (Directive 2006/43/EC)[17] aims at harmonizing the statutory audit functions in the EU by clarifying the duties of statutory auditors and improving the independence of auditors. According to the so-called Directive (Ernst & Young 2005):

a. Member states should establish Public Oversight Boards which approve and register the audit firms which deal with the education, quality control and disciplinary actions of the auditors.
b. Member states should provide sanctions including civil, administrative and criminal penalties, for inadequate execution of the statutory audit.
c. Publicly held listed companies should establish an audit committee, which is responsible for appointing and/or dismissing the audit firm for statutory audits.
d. To improve transparency of the audit process, public interest entities are required to disclose fees paid to the audit firm. This includes fees for audit services as well as fees for non-audit services.
e. An audit firm performing an audit for a group of companies to take full responsibility for the audit report in relation to the consolidated accounts.
f. Member states should either change the key audit partner dealing with an audited company every five years, or change the audit firm every 7 years, if the same audit firm continues to work.

3.1.7.5 Co-ordinating corporate governance efforts of Member States

Both the *Winter* Group and the EC believed that the EU should actively co-ordinate the corporate governance efforts of member states developing a code of corporate governance with comply or explain approach, also monitoring and enforcing the compliance.

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[17] Directive 2006/43/EC of the European Parliament and of The Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

To provide detailed technical advice on preparing corporate governance and company law measures, the EC has set up an expert “advisory group” which includes twenty non-governmental experts from different professional backgrounds such as investors, issuers and academics.

In order to facilitate convergence of national codes and provide recommendations to the EC, “European Corporate Governance Forum” has been established in October 2004, chaired by the EC and comprised of representatives from member states, European regulators, issuers, investors and academics. This Forum meets two or three times a year.

3.1.7.6 Future priorities of the Action Plan

EC has launched a public consultation on future priorities for the CLAP and the results have been disclosed in a report on July 7, 2006. According to the report, many respondents who answered the related questions on the public consultation stated their support on the CLAP, however also indicated their regulatory fatigue and their need for some time to digest the legislation.

EU’s future priorities are determined as to improve the competitiveness of EU companies in line with the Lisbon agenda and better regulation. Within this regard, modification and simplification of the European company law became one of the major objectives. Since the Company Law Directives were designed in the 1960s and early 1990s, they have to be updated. However EC believes that amending acts make the legislation more difficult to understand and implement, therefore it would be better to use codification method which puts together all the existing legislation in one single legal text, while modernization of the company law studies carry on.

3.1.8 Corporate Social Responsibility at EU Level

EU sees corporate social responsibility (CSR) as it is a tool for reaching its decided goal in the Lisbon agenda: “*to become the most competitive and dynamic knowledge-based*

economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”. Due to the EU’s employment and social protection objectives, CSR is also an aspect of European Social Agenda.

In order to launch a debate on how EU can promote CSR and how to build a partnership for the development of CSR, the EC issued a Green Paper, “Promotion of a European Framework for Corporate Social Responsibility” in July 2001. In this Paper CSR is defined as “*a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis*”.

The EC also issued a Communication (Communication from the Commission concerning Corporate Social Responsibility: A Business Contribution to Sustainable Development), on CSR in July 2002. Since then, there have been many initiatives led by EU to raise awareness on this issue. In 2002, EC set up the Multi-Stakeholder Forum to generate a consensus from a diverse group of different stakeholders. This Forum prepared a report in June 2004, including recommendations to advance CSR in EU and in international level. In the report, stakeholders could not reach a consensus on whether there should be European standards on CSR or there should be company reporting requirements.

The EC issued its second Communication on Implementing the Partnership for Growth and Jobs: Making Europe a Pole of Excellence on Corporate Social Responsibility in March 2006. In the Communication, the EC underlined the importance of the co-operation between member states. Also, the European Parliament published in March 2007 a report on “Corporate Social Responsibility: a new partnership”. Also a Conference titled "CSR at the global level: what role for the EU?" took place on December 7, 2007 in Brussels organized by the DG Employment, Social Affairs and Equal Opportunities.

Today, CSR issues such as equal opportunities for job opportunities, enhancing women‘s employment, increasing labor standards and protecting employee health and safety and human rights and environmental improvement can be seen also an integral part of corporate governance.

In general, many business representatives in the EU and the EC do not believe that it is necessary to pursue a binding regulatory approach at EU level on the promotion of the CSR. European Coalitions For Corporate Justice (ECCJ), which is a Europe-wide coalition, including national level civil society organizations, together with international NGOs and Brussels based NGOs, issued a report titled "Corporate Social Responsibility at EU Level" in November 2006, stating their views contrary to EC that "although voluntary initiatives can be successful in some cases, regulatory measures are necessary to ensure all corporations abide by national and internationally agreed standards, whichever provides the higher standard." In the report ECCJ recommends that: board members should have a legal obligation to respect environment, human rights and social interests including international standards such as ILO core convention, OECD Guidelines for Multinational Enterprises and European Declaration of Human Rights; in case of non-compliance there should be redress mechanisms; compliance to OECD Guidelines should be prerequisite for European companies which ask for export credit guarantees, subsidies and public procurement contracts; there should be annual mandatory reporting requirement for the companies regarding the environmental and social impact of their past activities; a list of violators should be published by the EC.

3.2 IMPLEMENTATION OF CORPORATE GOVERNANCE IN EUROPE

3.2.1 Convergence and Divergence Areas in CG Practices among EU Members

As the European member countries improve their corporate governance standards in accordance with the new Recommendations and Directives of the EU there is a growing trend of convergence between countries. However, there are still some constraints such as culture, traditions, different types of ownership and organizational structure, different company and securities legislation and the level of development of the capital markets which may result in divergence in the practices. For instance in Germany, corporate governance and business structure is based on co-operation and consensus, while in the UK, the business culture relies on a market-oriented and more competitive structure. Hence, it is not very surprising to see work councils and an employee co-determination system in German companies (Weil et al. 2002, p.29).

According to a study conducted by Weil, Gotshal and Manges (2002) on behalf of the EC, it has been found out that the greatest distinctions in corporate governance among EU member states appear to result from differences in law, rather than from divergences in the recommendations of the corporate governance codes of the member states. Although there has been some extent of harmonization in corporate law throughout the EU in recent years, there are still legal differences, mostly grounded in national attitudes which are the most difficult ones to change. The origin of the legal systems is based on different foundations as well. The legal system of Ireland and UK is based on Common Law with English origin, whereas Germany and Austria adopt German origin Civil Law; France, Belgium, Greece, Italy, Luxemburg, Netherlands, Portugal and Spain adopt French origin Civil Law and Denmark, Finland and Sweden adopt Scandinavian origin Civil Law. However, all the codes include a relatively common approach (Weil et al. 2002, p.3, p.32).

3.2.1.1 Surveys, studies and researches

In Continental Europe, the principle-based “comply or explain” approach is implemented; however, there is a great difference in how this approach has been implemented. For instance in Germany, Spain and the UK, the “comply or explain” approach has been included in the law, where in Italy, companies must declare their compliance according to the stock exchange corporate governance code. In the OECD Survey of OECD Countries (2004, p.52), it has been stated that German authorities reported a compliance rate of 70 percent where according to the report of the Spanish authorities this rate for Spain is 80 percent.

According to the 2007 Report of Heidrick & Struggles, which covered Europe’s top 300 companies’ past 8 years corporate governance practices, the gap between leaders and laggards has reduced three-fold. As a result there is less disparity between countries and the difference between the highest and lowest performing countries has dropped from 9.5 in 1999 to 3.3. points in 2007. According to the study UK, Netherlands and France are the leading countries where Germany, Italy, Spain, Belgium and Portugal are below the EU average (Heidrick & Struggles 2007, p.3).

In the following parts, we will discuss the main divergence areas in the member states codes and implementations.

Ownership structure

According to the study by Faccio and Lang in 2002, control of the 10 largest families as a fraction of market capitalization is 34 percent for Portugal, 30 percent for Belgium, 29 percent for France, 21 percent for Germany, 20 percent for Italy and only 4 percent for UK (in Morck et al. 2005 pp. 657-722).

According to the Standard and Poor's Commentary Report "Can Family-Owned Companies Mitigate Corporate Governance Risks Associated With Family Control?" (2005 pp.2-3) multiple voting rights are still a common feature in countries such as the Netherlands, Sweden and France in order to prevent hostile takeovers (Dual voting and voting caps in France; priority shares and multiple voting rights in The Netherlands; multiple voting rights and pyramid structures in Sweden; voting right ceilings in Germany; and shareholder agreements and pyramid structures in Italy).

Board structure and its working style

According to the study of Heidrick & Struggles, in the EU, there exist three types of board structures. In some of the countries such as Denmark, Austria, Germany, Netherlands and France, there is the two-tier system in which the supervisory board consists of "outsider" board members and management board consists of executive directors. In the EU 22 percent of the companies use this system. The majority of the member states have unitary board systems such as Ireland, UK, Spain and Luxemburg. The board is composed of both executive and non-executive board members. In the third type of board structure, executive and non-executive two board system exists, however some executive directors can sit on the executive board like Belgium, Italy, Sweden and Portugal (Weil et al. 2002, pp:43-44; Heidrick & Struggles 2007, p.7).

Generally both in the unitary and the two-tier system, board members are elected by shareholders, in some countries such as Germany, Sweden, Denmark, Austria and Luxembourg; employees may elect some of the supervisory members, as well. In Finland and France, company articles may provide some provisions for such an employee representation in board without voting rights (Weil et al. 2002, pp:43-44). According to the study of Heidrick & Struggles (2002, pp.7-15), unitary boards hold more meetings

than the ones with two-tier structure. The other findings relating to the composition of the boards and the board committees in EU countries are as follows:

a. The UK, the Netherlands and Sweden have the lowest (8.3, 8.6 and 10.8 respectively) and Germany has the highest (19.1) average number of the board members, where the average number of board members in EU companies is 12.8.

b. The number of independent non-executives members has risen from 37 percent in 1999 to 54 percent in 2007 in EU. Employee representatives comprise 10 percent and shareholder representatives comprise 19 percent of the board composition in 2007.

c. The boards of the EU are still more domestic than the companies itself. Countries like Germany, Spain and Italy are largely closed to non-national Board members (only 7 percent are non-national), where in UK and Netherlands, 30 percent of the boards have non-national members.

d. The lack of gender diversity in boards is still a problem in EU where 39 percent of the boards do not have women in their board. Sweden is the leading country having 21 percent of women, while Portugal is the last, having less than 1 percent.

e. Directors' remuneration has increased from 33.800 Euros in 1999 to 72.000 Euros in 2007. Directors' remuneration is the highest in Spain and UK and the lowest in France. Disclosure on remuneration is 80 percent in the EU companies. Portugal is the only country which still does not disclose remuneration and in Spain and Italy, the disclosure level is also very low.

f. In the EU, there is a greater use of Board committees, in 2007 98 percent of the EU companies have audit committee, 95 percent of them have the remuneration committee and 80 percent of them have nomination committee. 45 percent of the companies have audit committee with fully independent members, while this number is 40 percent for the remuneration committee. Strategic committee comprises 50 percent of the French companies, while ethics, corporate social responsibility and corporate governance committees exist in one third of the companies in UK.

Disclosure

There is a converging trend of both the type and the amount of the information that is disclosed by the listed companies in EU. Corporate governance codes are one of the major driving pressures on the convergence of disclosure; however there are still some differences on the disclosure requirements of the EU countries. Disclosure reforms are more concentrated on the structure ownership, board remuneration and director independence (Weil et al. 2002, pp 5-6).

Member states were invited to take the necessary measures regarding the Recommendation on Directors' Remuneration by 30 June 2006 either through legislation or best practices. The EC has reviewed the implementation of the so-called Recommendation and published the findings of the evaluation in a report in July 2007. In the report it was indicated that after the evaluation a large majority of member states have introduced high disclosure standards with regard to the remuneration of individual executives. Recommendation on shareholder approval of share based incentive schemes was also well accepted by the member states. However, only a few member states have followed the Recommendation on disclosure of the remuneration policy and shareholders vote on the remuneration criteria of the board (Heidrick & Struggles 2007, p.9).

EU has made considerable progress in harmonization of accounting, auditing and corporate governance via IFRS and ISA within the context of FSAP. Starting from 2006, the annual accounts of the listed companies are drawn in line with IFRS. According to the Standard 24 of IFRS, detailed and specific disclosure of related-party transactions is required. On the other hand, sometimes the implementation of the legal aspects can be still poor in some of the member states. For instance, some disclosure requirements on material related part transactions have been introduced in Consob (Securities Exchange Commission of Italy) in 2002, however there is still insufficient disclosure, coming from the listed companied due to the vagueness criteria of materiality (Enriques & Volpin 2007, pp 117-140).

Shareholder rights

EU has taken significant steps to increase minority shareholder rights like authorization of shareholders to approve some transaction and some forms of executive compensation. More EU countries are introducing laws to facilitate the shareholders to participate and vote in general meetings. In France and UK, electronic signature law has passed which enables voting by electronic means such as internet. In Germany, a law has been enacted in 2000, enabling proxy voting by fax, e-mails and phone (Weil et al. 2002, p. 79).

In the EU, some member countries require some mechanisms before the general meeting such as share blocking or registration requirements, proxy voting requirements, the rules for voting shares held in custody and notice requirements which pose impediments in cross-border investment which are all practices disadvantageous for the shareholders. Although the principle of the share voting proportionality is recognized by member states in general, many member states still allow various classes of shares to be issued or allow exceptions in their laws (Weil et al. 2002, p. 41).

According to the Euro Stoxx 50 Survey by *Die Wertpapier Spezialisten* in 2001, only 17 out of 43 European companies comply fully with the one-share-one-vote principle. The findings show that 35 percent of them use multiple voting rights, 26 percent of them use golden shares, 23 percent of them use a ceiling on voting shares and 16 percent of them use non-voting shares (in Weil et al. 2002, p. 40).

3.2.1.2 Analysis of the high level group on the Company Law and Codes

The authors of the CLAP - High Level Group of Company Law Experts - also known as *Winter* Group have issued a Report prepared for the European Corporate Governance Conference of October 18, 2004 on European Corporate Governance in Company Law and Codes. We will focus on the major outcomes of the analysis regarding the convergence and divergence developments of the EU Member countries (Hopt et al. 2004, pp.60-65).

The major diversity of the corporate governance systems in member states lies on the differences of the ownership structures and various ways of regulating these structures. In

EU, concentration of ownership prevails, but in different patterns. In Germany, there is a strong concentration of ownership in a small group of financial institutions, mainly banks and insurance companies. There is a trend of replacing these groups with a larger group of international institutional investors such as pension funds and investment funds. In the UK and the Netherlands, institutional ownership is already prevailing and these institutional investors act collectively to exercise their voting rights and make the governance research together. Now, governments started to focus on the ownership of these small numbers of large institutional investors, their disclosure requirements on voting policies and conflict of interests. In Nordic and Southern European countries, family ownership, multiple voting rights, pyramid structures and cross holdings prevails. There is a trend of dilution of these structures and replace with institutional investors; however dominant shareholders resist this trend (Hopt et al. 2004, pp.60-65).

Divergences on the patterns of the ownership structure result in diverse regulation on the area of the requirements for independent non-executive directors in EU. In the UK and Netherlands, employees, representatives of employees and shareholders are not considered as independent and have very strict rules on the independence requirement. In Germany, substantial independency requirements for supervisory board are not regulated, probably considering that the shareholder and employee representatives are the outsider board members. In France, directors representing dominant shareholders can be considered as independent if they don't take part in the control of the company. In Denmark, independence requirements don't disqualify representatives of controlling shareholders (Hopt et al. 2004, pp.60-65).

Similar corporate governance issues encourage convergence on the corporate governance regulations of the EU members. For instance, member states make regulatory reforms in common key areas in particular functioning of boards, its committees and executive remuneration. However, the way these issues are dealt with differently, due to the different traditions and practices. So, according to the Report, rather than uniformity and harmonization in detail, flexible recommendations by EC will result in convergence in corporate governance codes and related laws with similar lines. Harmonization is also seen as a constraint on competition. The regulatory competition in EU regarding the listed companies, which does not exist at the moment, may lead to convergence of regulation (Hopt et al. 2004, pp.60-65).

Finally, in some of the member states the corporate governance code is a part of company law and applied to the companies whose registered offices place is in that member state, regardless where their shares are listed. Other member states' codes are part of their listing regulations and applied to the companies listed in that member state, regardless of where their headquarters are registered. This results with overlapping or conflicting requirements for the companies which have multiple listing or the ones that have their listing and registered offices in different member states. Report supports that the problem must be solved in EU level (Hopt et al. 2004, pp.60-65).

3.2.1.3 The impact of the institutional, political and economical dimension on corporate governance process

In this section we will discuss how different institutional, political and economical developments can result in divergent corporate governance systems by focusing on Central Eastern European (CEE) countries and two Mediterranean member countries (Italy and Spain) in the EU.

Corporate governance in Central Eastern Europe

"Europeanization" is defined by *Radaelli* (2000) as: "*the set of processes through which the EU changes the logic of political behavior at national level, by becoming part of the domestic discourse, political structures and public policies*" (in Grabbe 2003 p.247).

Corporate governance regulation in CEE is Europeanized through the accession process. The *acquis communautaire* and single market norms caused harmonization in legislation and adaptation of macro-institutional structures. CEE countries exported market regulation models of modernization of corporate law and corporate governance best practices from Western Europe which helped them to gain domestic support for reforms as well as financial support from international financial institutions. Liberalization, marketization and privatization were the prerequisites for both transition and membership of the Union. By signing the Association Partnership Agreements, ECC countries were already promised to implement the market economy. In the Association Partnership Agreement, the Czech Republic's one of the short term economic reform priority was improving corporate governance by accelerating industrial and bank restructuring, while for Estonia and

Slovenia it was preparing pensions reform. Romania's short term priority was banking privatization (Grabbe 2003 p.258).

Nevertheless, CEE did not take one single type of model and tried to adopt it into their legislation, but rather tried to combine a variety of elements from both Anglo-Saxon and Rhenish models. Poland and Hungary tried to adopt a mixture of neo-liberal elements, downsize the predominance of the state and promoted labor market flexibility with more Germanic and Latin characteristics, while Czech Republic experience German-style of concentrated ownership and weak legal protection of minority rights, but applied new mechanisms like creation of investment privatization funds as US-style of securities regulation as well (Grabbe 2003 p.250).

In result, CEE practices are quite different than EU models. For example Hungary chose the two-tier board system like Germany and many aspects of corporate law is also similar to Germany; however although the structures and legal frameworks are the same, practices are quite different than each other due to the inactive shareholders and ineffective impact of the corporate governance structures on the company's strategies and policies in Hungary. However, economical policies of Hungary were quite successful in shaping the institutional settings in the transition period. Privatization process was very successfully implemented by allowing foreign firms and individuals to participate in all privatization transactions. Moreover, institutional settings on banking law, bankruptcy law, etc were quite coherent which helped Hungary to create of a more transparent corporate structure. Hungary has been the fastest in breaking the firm-bank-state ties and sold 90 percent of the shares of the financial sector to foreign investors, by the end of 1997 (Grabbe 2003 p.252).

In Poland, privatization process was quite different than Hungary. It was slower than Hungary and work councils were active in the privatization process and intervened in the emerging governance structures. Worker councils were able to keep the control over privatization projects. After the corporatization of SOEs where the state still remains the owner, the supervisory board was composed of one-third of representatives elected by the employees (Grabbe 2003 p.252).

On the other hand, Czech privatization process was quite different than Hungary and Poland and resulted in the cross-ownership among banks, investment funds and firms like

the Germanic model. On contrary to Germany, this result had a negative influence in economical growth and capital market development. The small number of banks largely controlled by banks still has an influence on the financial market (Grabbe 2003 p.252).

Socialist past and top down approach of these countries, as well as the inadequacy of the institutions, social settings and enforcement in many areas constrained the efforts of fostering the corporate governance practices in these countries. Nevertheless, it also shows that foreign investors have a big influence on the companies such as in their transparency practices and on governments in persuading them for radical reforms on the formulation and implementation of the respected regulations in terms of securing property rights, implementing rule of law and protecting minority shareholders' rights. Foreign investors could also be good teachers for educating the management in transition economies for sound corporate governance practices (Walkner 2004, p.12).

The examples that are given above shows that, even the same economical objective (marketization and liberalization) and mechanisms (privatization process) are used for the change in structures of the corporations in the transition countries, it does not give the same result in the end. Due to the corporate culture, legal frameworks relating to the banking, corporate and securities law and historical background and traditions of the institutions and distinct institutional players, even if the same features of the corporate governance models are adopted to the transition countries, the corporate governance framework and its effect to the economy differs from Western European models and even from each other.

Two Mediterranean countries: Spain and Italy

Due to EU harmonization pressures and the internalization of the economies of Spain and Italy, there has been some convergence in these two countries' corporate governance models. However, if we look at their corporate governance models, we see that despite equal pressure for European harmonization and international competitiveness, banking laws and other related regulations as well as the protectionism of the state have shaped these countries' corporate governance implementations in different directions (Aguilera 2003, pp.23-69).

Shareholders are in the form of block shareholders in Italian corporations who play an active role in issues such as dividend policy, merger strategy of the firm and capital structure. SMEs are usually controlled by a single individual or a group of shareholders who are often members of the same family. These SMEs do not have state or foreign capital, since the family controls the firm. The domestic non-financial sector owns 82 percent of the capital of listed firms in Italy. Banks are usually state-owned and 28 percent of the listed firms have state-ownership (Aguilera 2003, p.24).

Italian corporate governance is characterized by high ownership concentration and pyramidal groups (family-owned, coalitions or state) controlling the quoted Italian firms. Financial institutions, including banks do not play an active role in corporate governance such as corporate monitoring due to the 1936 Banking Law which prohibits banks from holding equity participation in industrial firms and draws a sharp division between commercial and investment banks. This separation between industry and banks is a very similar practice to the Anglo-American system, but quite different from Continental Europe's model. Since this Law prevents the development of strong bank-industry relations, banks are not generally involved in economic activities. Furthermore, the Italian stock market also plays an insignificant role in the entire economy of Italy. After the favorable tax regime of 1994 for the companies choosing to go public, the number of listed companies has increased in the last two decades. In 1998, a couple of regulations regarding shareholders' agreements, internal controls and public bids were introduced by the *Draghi* reform which fostered the minority shareholder rights and encouraged more shareholder activism. Since the institutional investors such as insurance companies and mutual funds have small shareholdings and often owned by banking and industrial groups, their role in monitoring corporate performance is also very limited. So, in sum, restrictive investment regulations of the government and the corporate culture of the whole picture prevented not only the dynamism of corporate governance but also the development of acquisitions and emergence of financial institutions (Aguilera 2003, p.28).

Spain's industry also includes many SMEs and most firms are owned by state, banks and foreign investors, however in contrast to Italy, family-owned large enterprises are not predominant. High ownership concentration (listed companies are often under absolute or major control), narrow stock market, interventionist government, the leading role of the

banks, decrease in state-ownership and open perspective to FDI can be summarized as the typical features of Spain's corporate governance. Since the integration of Spain into the EU, Spain is confronted by high foreign capital participation, like the Spanish auto industry, Europe's third biggest, is entirely foreign-owned. However, banks have been extremely protected against competition from foreign banks. Also, because of the dominance and state-protected character of the banks in financial market in Spain, up to the 1990s, banks played a very important role in corporate governance and there are no restrictions for the commercial and state-owned banks to participate into non-banking business, like participating in industrial holdings. Institutional investors, which are mainly the investment funds, do not have the power to influence the market, since their portfolios are not composed of stocks, due to the composition of particularly fixed interest bearing bonds (Aguilera 2003, p.28).

These different examples show how the government policies on the development of the industry, openness to the foreign investment and foreign ownership, the choice of protectionist and restrictive policy or liberal market mechanisms shape the institutional infrastructure of the entire markets and make a decision which major actors will play the leading role in corporate governance.

3.2.1.4 Some poor governance and regulatory reform examples

In this section we will examine the recent legal reforms on corporate governance code and corporate law in Germany, France and Italy due to the poor corporate governance practices.

In Italy, neither the board of directors nor the board of auditors has been able to exercise effective control over managers up to now. Italian corporate governance was characterized by high ownership concentration, pyramidal groups (family-owned, coalitions or state) controlling the quoted Italian firms and no mechanism for inside or outside corporate control. Moreover Italian corporate law has historically provided poor protection for investors, while enforcement institutions, such as courts or Consob were also ineffective to recover the deficiencies of the law (Enriques & Volpin 2007, p.79).

The *Parmalat* scandal in Italy at the end of 2003 is a very good lesson for Europe in which lack of disclosure and transparency on both in financial reporting and corporate governance practices and audit failures, together with inefficient board structure can be detrimental for

not only the shareholders and stakeholders, but also to the whole economy. Creation of fictitious accounts, transactions and assets in offshore companies to conceal debts; off-balance sheet financing; fake contracts concerning ten subsidiaries in Cayman Islands to show the banks to raise cash and lack of independent board members (a board composing of mainly family members, with three independent board members out of 13 members, one of them being the former head of a bank that lend money to *Parmalat*) have resulted in 14.8 billion Euros of company debt. The owners of the company had siphoned off 500 million Euros over 8 years into their private travel company (Derman 2004, pp. 79-81).

Surprisingly reforms of 1998 in Italy, before the *Parmalat* scandal were aimed to strengthen the powers of board of auditors and tighten their independence requirements, additionally enabling the executive directors regularly inform the board of directors and the board of auditors of business developments and related-party transactions.

Nevertheless, Italy has introduced a new reform in company law in 2003, for the related party transactions. Directors who have a direct or indirect interest on a transaction that he/she will realize have to disclose this to both board and board of auditors and transactions in which the CEO has an interest needs an approval from the board beforehand. A mandatory justification is also required to have an explanation of the board resolution regarding the reasons of the transaction and the benefits deriving to the company. This explanation must be even more in detail, if the decision is given under the influence of its parent company (Enriques & Volpin 2007, p.131).

In Germany, banks have traditionally played a fundamental role in listed companies due to their shareholdings in the companies and proxy voting practices for shareholders. However supervisory boards composed of employees and bank representatives have been ineffective in monitoring management and blockholders. The 1998 Reform on control and transparency was the first important steps for enhancing the board and auditor's duties and responsibilities. By this reform functions of supervisory and managerial board have been renewed and strengthened. Management board is now required to report the supervisory board over risk management, budget and business plan issues, while supervisory board have to meet at least four times a year and its duty and role has been enhanced in terms of election the auditor and its relation with the auditor. The external auditor and the

management's relation has been limited, the auditor has to send its report directly to the supervisory board (Enriques & Volpin 2007, p.130).

In France, managerial power has historically been concentrated in the hands of the chief executive officer, who was also the chairman of the board by law. However, the recent regulatory reforms allowed companies to separate the roles of chairman of the board and chief executive officer.

In order to strengthen the shareholder rights in concentrated ownership structure of the companies, Germany has already banned multiple-voting shares in 1998. The German government has established a Commission, Government Commission on the German Corporate Governance Code, composed of business experts to advice the government in view of amendments to the existing law on corporate governance areas. Many of the recommendations of the Commission are now the foundations of the latest reforms in Germany. For instance, due to the advice of the so-called *Cromme*-Commission, Germany has introduced its first corporate governance code in February 2002. Germany also revised its tax code in 2002 to exempt capital gains from sales of shareholdings held by corporations to encourage firms and financial institutions to disentangle their cross-shareholdings. Italy did the same in 2003 (Enriques & Volpin 2007, p.132).

In order to increase the effectiveness of voting rights of shareholders, France and Italy have focused on the practices on shareholder deposit before the general meeting which restricts the selling rights of the shareholders and discourage them to use their voting rights. For instance, in France, the deposit of shares for up to five days prior to the meeting was a requirement; however a new legislation has been introduced in 2002 providing that shareholders remain free to sell their shares up until the day before the meeting. The same share blocking requirement was also valid in Italy until 2003, the default rule is now "no deposit obligation", although company bylaws may still require an up to two-day deposit obligation (Enriques & Volpin 2007, pp.128-130).

France and Italy has lowered their minority ownership thresholds in order to enhance the effectiveness of minority shareholder rights. For instance, France has lowered the threshold for the right to call a meeting from 10 to 5 percent (Italy has lowered from 20 to 10 percent)

and for the right to ask to the court to appoint an expert for reviewing the transactions from 10 to 5 percent (Italy has lowered in the same extent).

Italy, Germany and France also made reforms concerning the private enforcement (by shareholders lawsuit) (Enriques & Volpin 2007, p.133). For instance in Italy, shareholders holding up to 5 percent of the shares had the right to open a derivative lawsuit on behalf of the company, against directors of the company for causing the damages. However, due to the high threshold and high costs in case of losing (the losing party in a suit has to pay the winner's lawyer fees), derivative action was not common. Italy made contingency fees (lawyers' fees that are owed only if the client wins) legal in 2006 and the threshold for a shareholder suit was reduced from 5 to 2.5 percent in 2005. Moreover, minority shareholders have been enabled to sue the parent company for damages stemming from abuse of its control powers (Enriques & Volpin 2007, p.132).

Germany has introduced even a better and more effective reform in judicial field in 2005, more closed to US shareholder litigation system. Shareholders representing at least 1 percent of shares or shares worth at least €100,000 may bring a derivative suit against directors and lawyers' fees were made more favorable for plaintiff shareholders. If the issuer violates to disclose material information, reforms in 2003 facilitated the shareholder suits for the damages. In 2005, the procedures for securities class action lawsuits are also introduced which Italy and France does not have such a development in their judicial system (Enriques & Volpin 2007, p.133).

Despite the strict reforms introduced in Italy, there is still a lack of corporate governance culture concerning board structure and transparency. According to the 2007 study of Heidrick & Struggles (2007, p.24), the majority of the firms are family-owned/state or public bodies in Italy and the legal protection of investors is still not enough. CEO and Chairman is the same person and there is still no clear distinction between executive and non-executive board members. Despite the reforms, there is still no disclosure culture, either. According to the so-called study, 88 percent of the companies did not disclose the remuneration packages. Boards are also closed to the non-nationals, which more than the half of the companies did not have any non-national.

Also in Germany, radical reforms on corporate governance improved many of the poor governance areas. However, due to the employee co-determination system in Germany, over-sized and ineffective supervisory board which is unable to fulfill its controlling duties is still an unsolved problem. Germany also made no reform on related-party transactions such as self-dealing of dominant shareholders. France and Italy has introduced some strict rules, however there is a risk that without improving the private enforcement in this field, this rules will be only on paper (Enriques & Volpin 2007, p.128; Jehn 2003).

3.2.2 The Role of Institutional Investors in Corporate Governance

During the last decades, there has been a significant and rapid growth in institutional investors such as banks, insurance companies, mutual funds, pension funds and hedge funds and their share in the equity market. Mutual funds and insurance companies comprise a major share of the assets both in the U.S. and in Europe. Pension funds' share in Europe, with the exception of the Netherlands, UK, Sweden and Ireland, is relatively small compared to US (Pazarbaşıoğlu et al. 2007). In the EU, pension funds accounted for around 30 percent of GDP in 2000, while insurance companies and investment funds assets were over 50 percent and 40 percent of GDP, respectively. The same year, the total value of institutional assets in Europe was around Euro11 tn, which implies around Euro 40 billion of annual revenue. The Table below shows the asset ratio of some traditional institutional investors in EU to the total GDP in 2000 (Davis 2002, p.4, p.21).

Table 3.2 : Assets of institutional investors (2000)

% of GDP	Pension funds	Investment funds	Insurance Companies
Belgium	6	30	42
Denmark	24	20	78
Germany	16	12	43
Greece	4	25	1
Spain	7	30	13
France	7	55	61
Ireland	51	144	45
Italy	3	39	21
Luxembourg	1	3867	117
Netherlands	111	25	65
Austria	12	40	24
Portugal	12	16	20
Finland	9	10	57
Sweden	57	34	90
UK	81	27	107

Sources: EFRP, FEFSI, CEA quoted in CEPS (2002)

The number of hedge funds, which are mainly managed from UK and US, has also multiplied from 530 in 1990 to more than 6,700 by 2005. Within the same time interval, assets managed by the hedge fund industry grew from $30 billion to more than $1.4 trillion (Pazarbaşıoğlu et al. 2007).

As discussed earlier, the potential conflict between shareholders and managers arising from imperfect information as to each others' actions, preferences and knowledge result in principle-agency problem, which provides managers to act in their own self-interest, rather than the interest of the shareholders. Nevertheless, there are some internal and external control mechanisms that affect the managerial behavior. Effective Board, who has the right to hire, fire and compensate managers, is an example of internal mechanism, where market or corporate control and laws can be shown as examples to external control mechanism. Due to the growth of institutional investors and their investment in equity market, institutional investors itself became a very important external control mechanism which influences managerial behavior either directly through their ownership or indirectly by trading their shares (Stuart et al. 2006, p.141).

The role of the institutional investors on the behavior of corporations contributing for the sound corporate governance practices of the companies can be summarized as follows:

1) Institutional investors can play a role as an activist shareholder (we will examine in the following Section in more detail) and have the power and incentives to remove the board members in case of bad management.

2) Institutional investors play an active role as monitor over board and board performance. In case of dissatisfaction of the board and its performance, they can either "vote with their feet" by selling their shares (exiting) or hold their shares by engaging in monitoring and voicing their dissatisfaction (exercise their voice) or hold their shares and do nothing (loyalty). However, empirical studies and experiences do not always show that institutional investors always act in shareholders' interest. For instance, according to the study of *Franks* and *Mayer* (1998) the role of the banks in hostile takeovers in Germany indicates that they did not act in shareholders' interest. However studies show that when the institutional investors have a larger stake in the corporation, their influence on the company is much greater (in Stuart et al. 2006, p.145). According to the study of *Payne*, *Millar* and

Glezen (1996), when there is an interlocking directorships and relation-type of investment, banks tend to vote in favor of management's proposals. Another study of *Brickley, Lease* and *Smith* (1998) also shows that pressure insensitive shareholders such as pension funds and mutual funds tend to more (proxy) vote against management's proposal than pressure sensitive shareholders such as banks and insurance companies (in Stuart et al. 2006, pp.141-147).

3) Large institutional investors can provide a mechanism to transmit information to the financial markets. This means that if they invest a company in a longer time, they can maintain information from the managers and this relation-type of investing can be optimal both for the investor and the management (Stuart et al. 2006, p.145).

4) Institutional investors, especially pension funds can be advocates for shareholders' interest and good governance. For instance Research Recommendations and Electronic Voting – a joint venture of National Association of Pension Funds in UK and Institutional Shareholder Service in US, provides a web-based research service on companies, recommendations on which way to vote and information about proxy voting. Also Hermes Focus Fund in UK and Relational Investors –a US Fund Management Company- offers to investors accession to corporate governance and shareholder engagement funds.

5) Institutional investors have an important role to play in the governance of companies in which they invest. This is also emphasized in the Communication of Modernizing Company Law and Enhancing Corporate Governance in the European Union. It's been also indicated that institutional investors have the responsibility of the institutional investors to disclose their investment policy on the corporations they invest and how they exercise their voting rights. This requirement will not only enhance the governance of the institutional investor itself, but also provide an opportunity for the investor to engage in corporation's affairs. Interestingly, a requirement for institutional investors to systematically exercise their voting rights is not considered desirable by the EC, in view of its potential counterproductive effects. EC believed that due to the lack of time and resources of institutional investors, there is a risk for them that they can vote in favor of any proposed resolution only to fulfill the requirement.

If we look at the legislation on the pension funds in EU level, the Directive 2003/41/EC of 2003 on occupational pension funds, introduces "prudent man principle" which ensures that

beneficiaries are well protected and “single license” requirement (mutual recognition), thus allowing cross-border provision of services and cross-border membership. However, the removal of fiscal barriers and barriers to the transferability of pension rights is needed for the free transfer of the services and EU is trying to solve this problem. Also, the UCITS legislation is being amended to widen the investment possibilities of funds to use derivatives, funds of funds, money market, cash and index funds. UCITS sets out common basic rules for the authorization and the supervision of investment funds as well as their activities and structures to facilitate the cross-border distribution of funds in the EU.

3.2.2.1 Constraints of institutional investors

Institutional investors such as mutual funds and pension funds manage the funds on behalf of their beneficiaries. After lending their fund to be managed professionally, in return beneficiaries demand profitable investment. It is also important for the institutional investors to satisfy their customers in the short-term, not to lose them through the transfer of the funds from their portfolio to another institutional investor. Therefore institutional investors are constrained by both the performance pressure and the time-frame of performance measurement and can not pursue long-term strategies. This leads to an agency-principle problem between owners and the managers of the fund (Derman 2004, pp.106-107).

Pension funds have a fiduciary responsibility which includes a duty of care and a duty of loyalty to protect the interests of the beneficiaries. Also they have a duty of precedence, which means the risks they take shouldn’t outweigh the returns they expect. Due to these duties, in case of a big decrease in the stock exchange, they take long-term bonds. This prevents the pension funds to have a long-term perspective in the listed companies they invest (Derman 2004, pp.106-107).

Sometimes there are some legal constraints that influence negatively the institution’s ability to vote. For instance share blocking (holding the shares to show up in the annual meeting) prohibits investors from trading prior to annual general meeting and leads to low voting turnout at the companies (Stuart et al 2006, p.156).

3.2.2.2 Institutional investors as activist shareholders

Shareholder activism is determined by European Corporate Governance Institute (ECGI) as "*the way in which shareholders can assert their power as owners of the company to influence its behavior*". It covers a variety of actions, such as voting with ones feet, voting campaigns related to proposals by management, "naming and shaming", openly talking to other shareholders, putting forward shareholder resolutions, calling shareholder meetings, private discussion or public communication with corporate boards and management and to replace individual directors or the entire board. Shareholder activism can be collectively or towards the other shareholders but not the board. The aim is mostly to pressure the boards and the managers of the firms to enhance the firm value and the governance effectiveness. Traditional activists are mutual funds and pension funds, however in recent years hedge funds play a very active role (Brenner 2008).

There is still a debate on the effectiveness and its impact on firm performance. Studies show that traditional activists have little impact on the firm performance, while hedge funds on the contrary bring positive returns (Brenner 2008). Most evidence indicates that shareholder activism can prompt small changes in target firms' governance structures, but has negligible impact on share values and earnings" (Karpoff 2001).

Opponents of the shareholder activism state that it has some extreme forms that weaken the strong companies by their extortion schemes. Some also say that portfolio managers lack the expertise to advise corporate management and therefore they should not play any role in the corporate governance. It has also been criticized that the primary role of the pension funds is managing the money for the beneficiaries, and by engaging the firm's affairs, they can diverge from this objective (Stuart et al. 2006).

In contrast, advocators of activism believe that it will result in improved governance. By monitoring the company, it will be beneficial for all the stakeholders of the company, therefore it has positive externalities. The ones who are in favor of activism also argue that monitoring leads to long terminism (Stuart et al. 2006). Also, when the board members perform badly, activists can be more effective and quickly in removing the board members.

Shareholder activism is seen more common in US ad UK. However, there are a number of shareholder rights groups in EU, as well. Dutch Shareholders Association is one of the

oldest one. In Germany and Sweden, since 1960s shareholders associations do exist. In UK, insurance companies are very active, followed by pension funds (Stuart et al. 2006). In UK, contrary to US, private pension funds are as active as the public ones. In US, private pension funds are the departments of the CFO's office, however in the UK, trustees are legally independent from the firm and do not act in favor of the company. Also they have the residual power to call an extraordinary general meeting with 10 percent of the share capital (Goobey 2006).

3.2.2.2.1 Activist hedge funds

Hedge funds have become critical players in both corporate governance and corporate control. They make an extensible amount of investment in a publicly held company and engage the target firm in taking governance and business decisions that realize value**.** They are very active in UK and US. London is Europe's leading center for the management of hedge funds. Legal scholars argue that due to the legal and cultural environment, UK is an ideal setting for shareholder activism to work (www.ecgi.org.2008). Wikipedia states that three-quarters of European hedge fund investments in 2006 ($400bn in total) were managed from London. According to a study of Barron's Online conducted in October 2007, the first two hedge funds, based on average annual return over the previous three years, are RAB Special Situations Fund (RAB Capital, London), being the first, and The Children's Investment Fund (The Children's Investment Fund Management, London) as the second.

Hedge funds differ from the traditional institutional investors in many ways. Hedge funds have large positions in relatively a few companies. When they want to engage in activism, they firstly determine whether a company would benefit from activism or not and if the answer is positive then they take a position. Hedge funds pursue activism to make profits out of it. Their activism is a profit-making strategy itself. Hence their activism is ex-ante and strategic (Kahan & Rock 2006).

On the contrary, traditional institutions such as pension and mutual funds, due to the regulatory constraints, political pressures and conflicts of interest, they are less effective in activism than hedge funds in terms of achieving governance changes and value creation opportunities. Because of all these barriers it's activism is less profitable than it is for hedge funds (Brenner 2008). Moreover, mutual funds must lower their cost and they have a

diversification strategy. However this strategy does not fit to the activist strategy which is relatively more expensive (Kahan & Rock 2006).

Traditional investors usually become active after they realize about a bad management of the company they invest, therefore their strategy is also ex-post in contrast with hedge fund's ex-post approach.

Hedge funds pursue corporate governance activism by influencing the business strategy and the management of the corporations. The tactics they're using are in various forms such as making public pressure on portfolio companies to change the business strategy, making a proxy contest to gain seats on the board of directors of portfolio companies and pursuing litigation against present of former managers (Kahan & Rock 2006).

The skeptic opponents of hedge funds fear about their short-terminism. However, there are some researches showing that the median holding period for completed deals is about one year (Brav et al 2008, in Brenner p.7).

3.2.2.2.2 Case studies

Hermes UK Focus Fund (Hermes), is an institutional investor which invest in companies that are basically sound but whose shares are under the market price, due to its strategic, governance or financial structuring weakness (Britannia 2006). This purely activist fund is set up in 1998 with a strong emphasis on corporate governance. By engaging the target company, Hermes aims to change the target company's governance structure, financial policies and/or capital/board structure it to improve its performance. Fund employs 50 high-qualified experts focusing on corporate governance issues (Goobey 2006, pp.58-59).

When Hermes ever wants to focus on a company, it first decides whether there is a value creation possibility by changing its governance structure. Hermes firstly approaches to the managers of the company on the firm's strategy, however if the managers are not open to dialogue, Hermes contacts with the chairman and non-executive directors or with the other shareholders. If the Board is also reluctant to follow their proposals, other institutional

investors can also be engaged. Finally Hermes can call an extraordinary general meeting and vote out an individual director or even the entire board, as an ultimate solution. However the latter solution is not chosen very often (Goobey 2006).

According to a study which analyzed Hermes activities, it's been found out that Hermes strategies were successful on changing the chairman and CEO as well as changing cash payouts and capital expenditure plans, but less successful on restructuring (Britannia 2006). Another example has experienced in France, for the first time in French corporate history. *Eurotunnel case* is known as a successful shareholder activism which resulted in ousting the board. Eurotunnel had some serious debt problems and *Adacte* -the small shareholders' association- accused the management of the Eurotunnel for the bad management and overpaid and asked from the court to call a general assembly and replace the board with more competent ones. Adacte also put forward a resolution for the board's dismissal at the general meeting held in 2003, however the resolution was rejected by the shareholders. However, till the next annual meeting, the number of private French shareholders had increased from 700,000 to 1 million and managed to ousted Anglo-French board in 2004 (Derman 2004, pp.100-101).

Our last example is about one of the well-known shareholder activism of a hedge fund on blocking an acquirer. *Deutsche Boerse (DB)* tried to acquire London Stock Exchange (LSE), however it failed. It renewed its attempt in December 2004. *The Children's Investment Fund Management* (TCI), a London-based hedge fund, announced its opposition on this bid and called an extraordinary general meeting to dismiss DB's supervisory board. *Atticus Capital*, a US- based fund, also joined TCI in opposing the bid and confronted DB. As a result, DB abandoned its bid and supervisory board decided to change the composition of the supervisory and management boards to reflect the new ownership of the company.

3.2.3 Corporate Social Responsibility

Corporate social responsibility (CSR) is the social aspect of corporate governance. The logic of this concept behind is taking the interests of stakeholders as a whole and promoting multi-stakeholder engagement. CSR calls companies to act responsible and widen their company objectives and missions, including the social and environmental aspects. CSR is

usually considered as a voluntary approach and very much related with "sustainable development", even sometimes overlapping (Henderson 2006, pp. 79-80).

CSR lies on the triple-bottom line approach referring to the economic, environmental and social factors in the assessment of the performance of the companies. Social and environmental reporting is usually made voluntarily. Nevertheless there are some international institutions such as OECD and The Global Reporting Initiative which has guidelines for reports. EU does not have a binding regulation on this topic yet; however some EU countries have already introduced laws for this triple bottom line reporting and launched various forms of CSR and socially responsible investment initiatives (Steurer et al. 2008, p.7).

a. Denmark introduced a law on mandatory "Green Accounts" for large companies in 1995.

b. France introduced a legal act in 2001, requiring listed companies to include social and environmental evaluations in their annual reports.

c. The UK's initiative on "Socially Responsible Investment Pension Disclosure Regulation" requires pension funds to disclose to what extent they are taking social, ethical and environmental issues into account. UK has also launched the "Payroll Giving" initiative as a special form of tax relief, providing tax exemptions to employees who give money to charities.

d. In Netherlands, the Green Funds Scheme aims to foster green investments such as organic farming, solar energy by granting tax exemptions to savers.

e. In 2000 Sweden launched the Public Pension Funds Act introducing disclosure guidelines for governmentally controlled pension funds.

f. In Germany, more and more organizations are publishing Environment or Sustainability Reports. In Italy, Spain and France, companies are also issuing reports (www.sustainment.de). German government enacted disclosure regulations for pensions to encourage Socially Responsible Investment.

3.2.3.1 Socially responsible investment

Socially responsible investment is related to both sustainable development and CSR, as it is the implementation of these principles in investment decisions by the investors. SRI can be based on social issues (such as human capital, community development, labor rights), on environmental issues (such as urban and industrial pollution, global warming), on ethical issues (human rights, manufacturing or distribution of weapons, tobacco or alcohol), or on a combination of these (Steurer et al. 2008).

According to the European Social Investment Forum (Eurosif), total amount of SRI by 388 European institutional investors (excluding the Nordic region) accounted for EUR 1,138 billion in 2006 and this number is growing tremendously primarily in the Netherlands, UK, Belgium, Italy, Sweden and Spain. The current market share of SRI is estimated to be around 10-15 percent of total investments in European funds under management (Steurer et al. 2008, p.8).

For instance, in Netherlands, SRI funds and shareholder engagement activities are growing together. In 1995, institutional and private socially responsible investors organized themselves as the VBDO (translated in English as the Association of Investors for Sustainable Development). As of 2004, SRI market size (private investment funds) reached to EUR 8,2 billion and SRI institutional market size is EUR 8,2 billion. Eurosif also states that the same year there were 23 ethical funds, 12 fiscally facilitated green and social-ethical funds in Netherlands.

3.2.3.2 CSR and SRI index

CSR and SRI ratings are conducted by rating institutions. Nevertheless, since, there is no consistent set of rating criteria for rating institutions to be used in their assessment, they apply their own CSR related assessment methodologies based on their own moral concepts and understandings of CSR with the help of international guidelines on CSR such as the guidelines of UN, the OECD and ILO and some of NGOs (Steurer et al. 2008, p.10).

After defining the rating criteria, rating institutions scan companies for relevant qualitative and quantitative information by conducting surveys, holding meetings with company directors and communicating with stakeholders (Steurer et al. 2008, p.11).

There are many SRI strategies they apply such as negative or positive screening, the engagement strategy and the integration strategy. The last two are the most common strategies in Europe. The negative screening approach is one of the oldest one which indicates excluding some of the so-called sin-industries such as weapon, alcohol or tobacco from the investment. On the other hand, in positive screening approach, companies are selected according to their positive performance on social and environmental issues. Engagement strategy which is used by the UK, the Netherlands, Belgium and Switzerland is also known as shareholder activism. Finally, the integration strategy, implemented by UK, the Netherlands, France and Italy, is the ultimate approach that fully integrates SRI considerations into company analyses (Steurer et al. 2008, p.12).

Most of the major stock markets have established SRI or sustainability indices. Among the most popular SRI or sustainability indices are, the Dow Jones Sustainability Index (DJSI), the FTSE4Good Index, and the DAXglobal Sarasin Sustainability Index. There are some conditions in order to be listed in these indexes. For instance, in order to be listed in the Dow Jones Sustainability Group Indexes, a rating agency-SAM investigates the firm's sustainability performance and then companies are ranked within their industry group and selected for the Dow Jones Sustainability Indexes.

The Table below shows some examples of the SRI rating agencies and their rating focus (Steurer et al. 2008, p.13-14).

Table 3.3 : Rating institutions and their rating focus of assessment

BMJ Ratings	Corporate Responsibility Rating Agency
Dutch Sustainability Research	SRI Research and Rating Agency
EIRIS	Ethical Investment Research Services
GES Investment	Company analysis on SRI and corporate governance
KLD	Social Investment Research Provider
Oekom research	Independent rating agency for success stories in sustainable investment
SAM	Independent asset management company for sustainability
Scoris	Sustainable Investment Research
Dutch Sustainability Research	SRI Research and Rating Agency
VIGEO	Independent CSR rating agency
SIRIS	Sustainable Investment Research Institute
Trucost	Environmental research organization, provides environmental data on companies and sectors, in financial terms

Source: Orse 2007 in. Steurer et al. 2008, pp. 13-14

4. CORPORATE GOVERNANCE IN TURKEY

4.1 SHORT OVERVIEW ON TURKISH ECONOMY AND CAPITAL MARKETS

Before analyzing the corporate governance system of Turkey, we will firstly have a brief look at the historical background with regard to economic policies of the government and at the capital market in order to understand the corporations' business culture and structures.

As stated in the task force report of the Institution of International Finance (2005, p.6), from the establishment of Turkish Republic in 1923 until the 1980s, the Turkish economy was heavily state-oriented. State-owned enterprises (SOEs) were established in 1930s with the aim to stimulate the economy, due to the under-developed private sector. The existence of big SOEs, state intervention in the economy and restrictions of newcomers into the market prevented the development of the private sector, investment projects and a competitive economic environment. The state had a key role being both owner and manager of the large industrial companies. An "import-substitution policy" was implemented as the major economic policy. Moreover, bank credits backed by state guarantees "crowded out" the private equity financing. Hence, during the 1950s and 1960s, the governments sponsored the private sector through subsidized loans and governmental contracts (Ararat et al. 2006, p.270). By 1960, the share of the public sector in total value added in manufacturing was 60 percent (Ökten 2006, p.249).

Beginning in the 1980s, the government policy shifted from an import-led and protectionist to an export-led policy favoring a liberal market economy. The government started its structural adjustment reforms. Privatization was put on the political agenda and from its start in 1985 up to 2005, the total proceeds from privatization efforts have amounted to 9.4 billion Dollars with more than half of these having been realized in the period of 2000-2005 (Ökten 2006, p.227). In the course of the liberalization and orientation towards a market-economy, the Capital Markets Law (CML) was enacted in 1981, followed by the establishment of the Capital Markets Board of Turkey (CMB) in 1982 and the Istanbul Stock Exchange (ISE) in 1986.

However, according to a task force report of the Institution of International Finance (2005, p.6), the high government deficits financed through central bank lending led to high inflation rates averaging 50 percent in the 1980s and 70 percent in the 1990s. As stated in a

pilot study of OECD on corporate governance in Turkey (2006, p.40), high interest rates, low economic growth, unpredictable tax rates and the overall instability of the macro-economical and political conditions have increased the cost of capital which resulted in the creation of the mixed industrial-financial conglomerate structures which diversified their business operations in order to minimize the financial risks. Gönenç (2006) indicates that during the period of 1987 to 1997, large shareholders in Turkish companies restructured their ownership within business groups through pyramid structures and cross-holdings. Therefore, these family-owned conglomerates, mostly composed of both industrial and financial (mainly banks) sector companies expanded rapidly.

After the 2001 financial crisis, in order to recover from the bad consequences of the financial and economical instability, a number of reforms, e.g. the bank restructuring and the stabilization program led by IMF, have been undertaken. According to a country brief of the World Bank on Turkey (2007), reforms led Turkey pass to another stage with an average of annual growth of 7.5 percent and an output increased by more than 40 percent in 2002-2006. Furthermore, the inflation rate dropped to one digit numbers, but as of 2006, it reached 10 percent. Today, with a GDP of US$402 billion, Turkey's economy ranks among the world's top 20. However, Turkey is still the World Bank's largest borrower in the Europe and Central Asia Region.

Turkey's accession process towards an EU membership and the positive financial environment helped Turkey to attract foreign capital inflows. According to a country brief of the World Bank on Turkey (2007), the lack of restrictions for foreign portfolio investors trading in the Turkish capital markets, led to an increase of foreign portfolio investments, reaching 1.939 million Dollars in 2006.

In the Table below, some equity market indicators of ISE are indicated compared to the EU average including 20 EU stock exchanges as of December 2005 (Küçükçolak 2008, pp.2-6).

Table 4.1 : Comparison of equity market indicators between ISE and EU average

	Turkey	**EU Average**
Market Cap. (in million Euro)	137,531	480.026
Total number of listed companies	305	472
Total value of share trading (in million Euro)	237,706	1,108,996
Turnover Ratio (Total value of share trading/market cap)	%173	%231

Source: **ISE and FESE**

According to this data, ISE is below the EU average in terms of market capitalization, number of listed companies, and turnover ratio - implying the liquidity - and the total value of share trading; however we must consider that stock markets of the UK, Germany and France, which already represent a significant part of the global market, are naturally bigger than the rest of the EU countries and their "country ratios" increase the EU average. On the other hand, ISE ranks first in competition with EU countries in 2005 in terms of index performance (Küçükçolak 2008, pp.2-6).

According to the country report of the IMF on the financial system stability assessment of Turkey (2007, p. 72), the equity market capitalization ratio of listed companies in Turkey to the GDP was only 40 percent in 2006, which is significantly lower than the EU average of 82,8 percent.

According to the annual report of CMB of Turkey (2007, p. 28), as of 2007, there were 623 publicly held companies registered with CMB, 325 of them were listed in the ISE. The ratio of the around one million equity investors in relation to the total population of 72 million is comparably low. The capital market can be described as relatively small, shallow, not liquid and highly volatile. Institutional investors and the value of their portfolio value are negligible. There are 41 banks and 104 intermediary companies dealing with capital market activities. As of 2007, the number of domestic mutual funds was 297 with 23,149 billion Dollar of portfolio value, while 60 foreign mutual funds had only 77 million Dollar of portfolio value. In the same year, 104 pension funds, 33 investment trusts and 16 portfolio management companies had a total asset/portfolio value of 3,932 million Dollars, 601 million Dollars and 26,651 billion Dollars respectively.

Institutional investors are the most important driving forces for the development of the sound corporate governance in both developed and developing countries. However in Turkey, because of the portfolio restrictions and other legal restrictions, institutional investors such as pension funds and mutual funds can not play an active role in the listed companies that they invest. Also, portfolio value of the mutual funds of developed countries in proportion of GDP is approximately 70 percent, where this ratio is 5 for emerging markets and only 4 for Turkey. Pension funds in Turkey are also quite young; they were introduced at the end of 2003. Each year the portfolio value and the number of participants are growing, however its value in proportion of GDP is still about 1 percent, where this ratio is 5 for Czech Republic and 11 for Poland. Moreover, only 11 percent of the pension funds are comprised of stock shares, while this ratio is 2 percent for the other funds in Turkey (Çolak 2008).

4.2 LEGAL FRAMEWORK AND REGULATORY AND INSTITUTIONAL BODIES

As Turkey became a candidate for EU membership at the Helsinki Summit in December 1999, it accelerated its regulatory reforms to harmonize its legislation in line with the EU. As stated in a special report of Fitch Rating on corporate governance in Turkish perspective (2007), following the bank and currency crisis of 2000/2001, the government took significant measures to strengthen the economy, restructured the banking system, deregulated the monopolized sectors and continued its tight fiscal policy in a broad range of fields. Some of the reasons of this crisis were said to lay in the complex ownership structure of holdings which also have bank assets; inter-company loans by group banks and; massive frauds by the use of off-shore subsidiaries. In terms of corporate governance, the crisis was a direct result of the lack of transparency in related party-transactions and in the cash circulation within group companies of holdings. The 2000/2001 crises marked a turning point in Turkish governance and led to a major re-structuring of the business resulting in the need to improve corporate governance practices and as a result of these improvements merger and acquisition activities by foreign banks and companies have increased. These structural reforms also included the reduction of the size of the public sector in the economy.

In the special report of Fitch Rating on corporate governance in Turkish perspective (2007), it's mentioned that as the economic conjecture was progressing by the restructuring process, starting from the banking system in Turkey, an increasing number of foreign investors wanted to enter the Turkish markets. Turkey became aware of the competitive advantage to attract more foreign capital by the implementation of good corporate governance. With more Turkish companies listing in international stock exchanges such as NYSE and LSE or issuing bonds in international markets, foreign direct investment has significantly accelerated in Turkey. Integration in international capital markets and the growing number of foreign investors can be identified as the most important driving forces for the enhancement of the corporate governance practices.

The very first response to these developments came from the Turkish business itself. In December 2002, the Turkish Industrialists' and Businessmen's Association (TUSİAD)[18] issued its Corporate Governance Code of Best Practice: Composition and Functioning of the Board of Directors. Although this code merely focused on only one of the aspects of corporate governance, the board of directors, it can be considered as the first initiative of the development of corporate governance in Turkey and shows the willingness of the business to take initiatives by itself.

Meanwhile CMB, as the regulatory and supervisory authority of the capital markets, aimed to restructure the Turkish capital market due to the increased competition conditions in the international arena and needed to adjust its regulations in line with the developments and trends of the developed countries on corporate governance issues. Within this regard, CMB initiated a project for setting up its own Corporate Governance Principles (CGP) by establishing a "Corporate Governance Working Group" composed of many distinguished experts from different departments of CMB in cooperation with the representatives of both Istanbul Stock Exchange and the Corporate Governance Forum of Turkey, a joint initiative of the *Sabanci* University and TUSIAD.

The draft of the CGP of Turkey used the "OECD Corporate Governance Principles" of 1999 as a benchmark; corporate governance codes, rules and related laws of developed

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[18] TUSİAD, an independent and non-governmental organization working for the public interest through private enterprise, was founded in 1971, according to the rules laid by the Constitution and in the Associations Act.

countries were examined by also taking into consideration the specific needs and business environment of the Turkish capital market.

In June 2003, the CMB finally issued its own Corporate Governance Principles for publicly held companies on a "comply or explain" basis and has revised them in 2005 to be compatible with the revised OECD Principles (2004). The principles are voluntarily applicable, however the listed companies are required to disclose a Corporate Governance Compliance Statement whether they comply with these rules or not, and in case of non-compliance they have to explain the reason and indicate the plan for change in the company's governance practices in the future, if any. This statement is required to be published as a part of their annual report.

CGP is composed of four main sections: Shareholders, Disclosure and Transparency, Stakeholders and Board of directors.

The shareholders part discusses the principles on shareholders' rights and their equal treatment, covering issues such as the shareholders right to obtain information, participate and vote in the general shareholders' meeting, obtain dividend and minority rights.

The disclosure and transparency part includes the principles for establishment of information policies in companies with respect to shareholders, public disclosure of related-party transactions, functions of audit firms and the periodical financial statements and reports.

The Stakeholder part regulates the company policy on stakeholders, employee participation in the company management, principles on relations with customers and suppliers, ethical rules and social responsibility.

The board of directors' part includes the principles on the functions, duties, responsibilities, composition, election, independence and remuneration of the board members and the structure and duties of the board committees.

As we will discuss more in detail, the Turkish corporate governance system is similar to Continental Europe, also following a "comply or explain" approach, voluntarily implementation rather than strict rules and regulatory laws. Moreover, the CGP also includes a separate section about stakeholder rights providing recommendations regarding

employee representation in the board and relations with suppliers and customers. Therefore, the Turkish corporate governance system can be considered as an insider model in principal. The CGP of Turkey is neither totally based on the Anglo-US-based models nor on the insider model of Continental Europe, but is a combination of both.

Turkey has a civil law system with the Turkish Commercial Code (TCC) having its origins in French law. Minority shareholder rights and issues related to the board members and executives are mainly regulated in the TCC. However publicly held companies and mutual funds, investment companies, portfolio management companies (and pension funds to a certain extend) are in the scope of the Capital Markets Law (CML) and its sub-regulations (by-laws, communiqués and decisions). As stated in the introduction part of CGP, the CGP of Turkey is aimed to fill the gaps of these legislations and giving a sign for the future legislation. Both the TCC[19] and the CML are in the process of amendment and there will be many radical provisions that are aimed to enhance the protection of shareholder rights.

According to the Banking Law in Turkey, the Banking Regulation and Supervision Agency (BRSA) determines the structures and processes of corporate governance and the applicable principles for the banks in Turkey, upon consultation of the Capital Market Board and associations of institutions. Based on this provision, the corporate governance rules for the banks are enacted through by-law in November 2006. This regulation covers seven principles mainly regarding the establishment of the institutional values and strategic targets, the determination of the duties and responsibilities of the board members and executives, the formation of a corporate governance committee, the capacity and knowledge of the board members, remuneration of the board and committee members and transparency of the corporate governance.

The Corporate Governance Association of Turkey is another important player in developing the culture and assisting the implementation of the best practices. It organizes board trainings, conducts academic research projects, develops case studies, publishes books, newsletters, articles and interviews on demand by journalists.

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[19] For more details see below, Section 4.5.1

Also the Corporate Governance Forum of Turkey provides training and education programs for the board of directors of joint stock corporations to better understand the role, duties and responsibilities of the boards and importance and benefits of corporate governance.

4.3 TURKISH CORPORATE GOVERNANCE SYSTEM AND ITS DIFFERENCES FROM THE EU

According to a pilot study of OECG on the corporate governance in Turkey (2006, p.11), the major characteristics of the Turkish corporate governance landscape are listed as:

a. Insider corporate governance model,
b. High degree of concentrated ownership,
c. Dominance of family-owned companies,
d. Tendency of pyramidal structures and high degree of cross-ownership between the financial and industrial group companies mostly within the roof of a holding company,
e. Limited degree of separation of ownership and control,
f. Multiple voting shares and privileged shares,
g. Bank-based financial system,
h. Civil law system.

4.3.1 Ownership Structure and Control

In Turkey, family-owned companies are predominant. *Yurtoğlu* (2003, p.16) found out that in 2001, more than 80 per cent of all publicly listed companies in Turkey were owned by families. Yurtoğlu (2003, p. 16) defines the corporate governance system in Turkey as "*the insider system with the insiders being the country's richest families*".

The separation of ownership and control is achieved through pyramidal or dual classes of shares in which the empirical analyses show that such arrangements harm minority shareholders. The study proved that such kinds of mechanisms result in significantly lower market to book ratios and high agency costs due to the conflict of interests between controlling families and minority shareholders. Moreover, according to the study, as of

2001, 65 percent of the listed companies were manufacturing companies, while 28 percent of them represented the service sector and 7 percent of them were financial companies such as banks, insurance companies and financial intermediaries. Conglomerates are quite young and most of today's largest 500 firms in Turkey are founded in the 1970s or later (Yurtoğlu 2003, p. 5).

According to a study of *Derman* (2005, p. 519), 35.9 percent of the listed companies in ISE were included in Turkey's top 500 industrial enterprises published by Istanbul Chamber of Industry in 2001. Therefore among these big enterprises, only 110 of them which are listed in ISE had the chance of accessing external capital other than their own resources or banking resources. Holdings often have banks in Turkey. 70 percent of the listed companies are either family-owned or a group company (or subsidiary) of a holding. As of July 2002, there were 16 holding companies which are listed and 14 of them were either family-owned or the group company. 70 percent of these family-owned holding companies, families hold more than 50 percent of the shares.

On the other hand, according to the findings stated in the Report on Corporate Governance in Turkey published in April 2005 by the Institute of International Finance (pp. 3-8), the largest domestically owned Turkish companies are mostly family-controlled. At least three-fourths of all companies are owned by families or a holding company controlled by a family. Also, most of the large Turkish companies which are the part of conglomerates are organized around a group-owned bank like in the Japanese model. Therefore income shifting and transfer pricing are considerable problems in pyramidal and cross shareholding structures. Moreover, according to the estimates, one half of the publicly held companies are controlled by a family or other forms of mechanisms often through multiple voting rights and/or privileged shares acquiring the board nomination rights. A single shareholder controls more than 50 percent of voting rights in 45 percent of the companies listed on the ISE. Also, market transactions are highly concentrated with the 25 most actively traded companies representing about three-fourths of the volume of the ISE. The five largest business groups account for about half of the total market capitalization of ISE.

Family-owned ownership is also common in most of the European countries such as Italy, France, Germany and Greece. For instance, in Italy family control more than 10 percent of

the total market value of the listed companies. *Faccio* and *Lang* (2002) report that families who are the insiders in most of the civil law system countries, own about 45 percent of more than 5000 publicly listed Western European countries (in Yurtoğlu 2003, p. 2). However, Turkey differs from the EU due to the fact that wealth of the company is concentrated in the hands of a few families. According to the 2007 Country Report of Fitch (p. 3), the members of the families as controlling shareholders also hold the managerial or executive positions. Listed companies in Turkey have compared to the EU level a lower floating rate. Family-owned companies are also a common feature of the economy in the EU, as we can find them for example in Sweden and other developed countries (even in the US), but those family-owned companies are usually "privately held". A direct control of "publicly held companies" by owners who are, in most of the cases, also directors of the company is a unique feature of emerging markets with the exception of the countries in transition (Ararat et al. 2006, p. 281).

According to the 2007 Country Report of Fitch (p. 4), it's been stated that in the last 5 years, several group companies in Turkey have merged sub-holding entities to simplify their ownership structures and shifted their stakes from financial sector to private sector in order to meet the transparency standards of the international markets.

4.3.2 Shareholder Rights

It can be stated that there is no shareholder culture in Turkey. The Stock exchange is seen as a platform to make short-term profits by the domestic investors. This can be due to the fact that state has had historically a predominant role in every aspect of economical and social activities of Turkey, and the citizens have always expected the government to set market mechanisms rather than being actively involved by themselves. An NGO culture is newly developing. As stated in the task force report of the Institute of International Finance (2005) on corporate governance in Turkey, shareholder participation to general shareholder meetings is low and shareholders do not often use the right of requesting information from their companies in Turkey. Institutional investors are comparatively underrepresented[20] and have only a low interest in good corporate governance, distinguishing Turkey from a

[20] See Section 4.1. above.

number of other emerging markets. Besides economical reasons due to the nature of Turkish financial markets as volatile and highly risky it can also be due to the fact that funds are not permitted to vote for corporate directors according to the existing legislation. The conflicts of interest arising between controlling shareholders and minority shareholders are a common problem for EU and Turkey. As we have mentioned in Section 3.1.7 above, the EU Company Law Action Plan includes initiatives regarding the problem of pyramidal structures and transactions within and ownership of group companies. Also in Turkey, as it is the case in the EU, shareholder protection is still insufficient because of the cost and length of judicial procedures (A survey of OECD Countries 2004, p.69).

As it is mentioned in Section 2.4.2, according to the Minority Shareholder Protection (MSP) Index ratings, Turkey's MSP was low, which implies less effective management and less investment protection. According to another study, La Porta et. al. (1998) rated Turkey as one of the countries with French law origins having the weakest minority shareholder protection (in Ararat & Uğur 2003, p.64). In this study shareholder rights are assessed in terms of criteria such as one-share-one-vote principle, allowing proxy voting by e-mail, cumulative voting, oppressed minorities mechanism and the shares not blocked before the general meeting. Turkey is rated with a score of 2 out of 6 in a 40 country assessment with respect to shareholder rights, with 51 out of 90 with respect to accounting standards and with a score of 4 out of 10 with respect to judicial efficiency (Ararat & Uğur 2003, p.64).

In Turkey, controlling shareholders play a leading role in the management and strategic decision for the group companies including the listed companies. This leads to the potential abuse of minority shareholders through the imposition of commercial conditions by the controlling shareholders at the expense of minority shareholders interests (Yüksel 2008, p.101).

The threshold for "minority shareholders" in Turkey to exercise certain rights, is 5 percent for publicly held companies according to CML and 10 percent for non-public companies according to TCC. The TCC as well as capital market legislation provides a number of rights for minority shareholder, such as the right to demand special statutory auditors to be appointed to investigate alleged abuses, the right to request from the company's internal auditor or the company to take action against directors who have failed to perform their

duties, the right to add an item to the agenda, the right to veto the release of management and the right to call an extraordinary meeting. However, the high threshold and also costs for legal procedures make minority shareholder protection ineffective in Turkey. For instance, in order to apply to the court for the appointment of a special auditor, the necessary expenses and the shares of the plaintiff should be deposited in a bank in advance until the action is included (Tekinalp 1994, p. 118).

In Turkey, shareholders either personally attend the general meetings in personal or are represented through a proxy. Since the proxy form must be signed by the power of attorney, proxy voting procedure is costly and not practical. Shareholders can exercise their rights by appointing shareholders as proxies. Moreover according to the Communiqué on Principles Regarding Proxy Voting and Tender Offer, proxies who are not shareholders can only be appointed in case there is no contrary provision in the articles of association of the corporation. According to the Article 360 of the TCC, share blocking by the custodian before the general meeting is also a mandatory practice which discourages shareholders to vote. However, the new European Directive on Shareholder Rights abolishes the existing constraints of the member states on the eligibility of proxy holders and the excessive formal requirements for the appointment of the proxy holder and requires member states to offer their shareholders electronic-voting and electronic participation to the meeting, which is not the case in Turkey.[21] Electronic proxy voting practice lacks integrity in EU. In Italy and Greece, electronic proxy voting is not provided, in France wet signatures are still required and the Greek regulation requires share blocking by custodians (Jones 2007).

The Shareholder Rights Directive also provides the shareholders with the right to ask questions and require the company to answer them. [22] According to the TCC, shareholders have the right to get information from the company and the internal auditors, however the right to ask questions is not explicitly regulated in TCC, but it also does not prevent this right to be executed (Tekinalp 1994, p.96). However, this issue is explicitly regulated in CGP of Turkey in detail.

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[21] See Section 3.1.7.2

[22] See Section 3.1.7.2.

In Turkey, families usually control the listed companies by pyramidal structures and multiple shares giving some privileges to controlling shareholders such as nomination or election of board members, two types or more then two types of shares with different voting rights, preemptive right to buy new shares (Ararat & Yurtoğlu 2008). According to the Article 387 of the TCC, basically the "one-vote-one-share principle" is respected; however the number of voting rights can be stipulated differently (multiple voting rights is possible) in the articles of the association of the company due to the lack of restrictive provision in TCC. Nevertheless, the CGP (Part 1, Article 4.5) encourages avoiding the privileges regarding voting rights.

According to TCC and capital markets legislation, the notice and agenda of the general meeting should be sent to shareholders at least 15 days before, while the CGP recommend a period of three weeks (Paksoy & Aziz 2004, p. 268). According to the EU Directive this period is 21 days, and in the case where shareholders can vote by electronic means the period is reduced to 14 days.[23] The CGP of Turkey is in line with this Directive, but the principles are not obligatory in Turkey. It will therefore be necessary to amend the current TCC and capital market legislation in future to be in compliance with the Directive.

4.3.3 Board members and CEO

Controlling shareholders play a key role in company management in Turkey. Most boards still do not operate independently from the block-holding shareholders. According to one survey stated in the task force report of IIF (2005, p.4), 80 percent of listed companies had at least one board member who was a member of the controlling family and in average; more than one-third of the board members are members of the controlling family. Parallel to this, *Küçükçolak* and *Özer* (2007, p.3) found out in their survey study that the controlling shareholders decide on the appointment of the board members and key executives; a kinship exists between the board members and major shareholders; and interlocking directorate is also a common practice. Since the families control more than 50 percent of the shares in the companies and/or have multiple voting shares/privileged shares with

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[23] See Section 3.1.7.2.

nomination rights, the owners of the company who have the majority of the votes or shares with nomination rights elects the directors.

In Turkey, there is like in the majority of the EU countries also a one-tier board appointed by the shareholders. There is neither any provision regarding the committees to be established in the board nor any requirement for the qualification of the board members in TCC. However, according to the CMB rules (Serial X, No:16, Article 28/A), listed companies should establish an audit committee composed of at least two non-executive directors. According to the CGP, the general qualifications for the candidates of the directors are determined. The CGP recommend besides the establishment of an audit committee composed of a majority of non-executive directors, the establishment of a corporate governance committee with a majority of independent directors and with some duties such as proposing any suggestions on the incentive remuneration of the directors, coordinating the work of shareholders relations division and constituting a transparent system for determination, evaluation, training and rewarding of candidates eligible for the directors (CGP 2003, Part IV, Board of Members, Arts 3.1., 5.2., 5.3, 5.7.).

The EU Recommendations on the role of non-executive or supervisory directors of listed companies (2005/162/EC, s 3.1.7.3) identify three areas with a particularly high potential of conflicting interests for the management: The nomination of directors, their remuneration and audit. In order to avoid any conflict of interests, the recommendations encourage the creation of nomination, remuneration and audit committees within the board with a majority of their members being independent directors.

In Turkey, contrary to the EU countries, remuneration and nomination committees as two separate units and an audit committee with a majority of non-executive independent directors do not exist.

In order to provide the minority shareholders to elect a member of the board of directors and auditors, principles of cumulative voting is regulated in the Serial: IV, No:29 Communiqué on Principles Regarding Cumulative Voting At Shareholders Meetings of Joint Stock Corporations Subject to Capital Market Law which strengthens the minority

shareholders to be represented in the board.

One important thing to be stressed is that neither the TCC nor capital market legislation requires for “independent board members” for the public companies, which is the backbone of sound corporate governance. Only for banks and real estate investment trusts, independent board member requirement is obligatory. However, according to the EC Recommendation, the board should have a sufficient number of independent members.[24] Nevertheless, CGP of Turkey regulate the criteria of independence in detail and recommend that at least one-third of the board of listed companies (not less than two members) is composed of independent board members, including the chairman of the board committees. The majority of the board members should consist of non-executives as well (CGP, Part IV, Board of Members, Art. 3.2., 3.3.1, 3.2.1, 3.3.5).

According to the Recommendations of EC[25], separation of the role of CEO and board chairman is an important issue to be covered by the national legislations. Although it is also recommended in the CGP of Turkey, its implementation is weak (Küçükçolak & Özer 2007).

4.3.4 Disclosure and Transparency

The CMB has issued financial reporting standards based on the IFRS[26] and are in effect as of January 2003. In a transition period of two years, the CMB permitted listed companies to publish their financial reports complying with either the CMB’s IFRS-based standards or the pre-existing CMB standards. As stated in a pilot study of OECD (2006, p. 49), since 2005, all listed companies are required to publish their financial reports either in accordance with the CMB’s IFRS-based standards or according to the original IFRS. The Turkish Accounting Standards Board (TASB) translated the original IFRS into Turkish in 2006.

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[24] See Section 3.1.7.3.

[25] See Section 3.1.7.3 above.

[26] IFRS are published by the International Accounting Standards Board (IASB).

Recently, the complicated and dual accounting standards have been simplified and unified by the enforcement of the CMB's Communiqué on Financial Reporting in Capital Markets (Serial XI, No:29), requiring all the listed companies, intermediaries and portfolio management companies to apply international financing reporting standards (IFRS) and international standards on accounting (IAS) which are recognized and implemented by the EU. The companies shall mention in the footnotes of their financial reports that they prepared their reports in accordance with the original IFRS. Therefore as TASB has translated the IFRS/IAS of EU into Turkish, this version will be taken as a reference for the Turkish companies. This is a significant step for Turkey in terms of transparency and standardization of the accounting and financial reporting in line with EU.

Also, according to the Article 9 of Serial XI, No: 29 Communiqué, corporate governance compliance statements are obligatory in the annual reports of listed companies in Turkey in line with the EU regulations. In the corporate governance principles compliance report, listed companies should disclose information such as structure and composition of board of directors and independent members; qualification of board members; internal control and risk management mechanism; number, structure and independency of the committees; remuneration of the board members; social responsibility; beneficial ownership, voting rights and minority rights, dividend policy, web-site and its content.

Moreover, according to the Article 8 of Serial XI, No: 29 Communiqué responsibility of preparation of these financial reports in terms of accuracy and adequacy belongs to the board collectively which is also in line with the EU legislation.

Individual board member remuneration should be disclosed according to the EU Recommendations.[27] Also the CGP of Turkey, Part II, Art 3.2.2./j, recommend the disclosure of the remuneration, bonuses and other benefits of the board members and executives including the determination criteria on the compensation in the company's annual report. However provision regarding the compensation in the CGP of Turkey, it has been noted in a footnote that this information should be disclosed to the public in a table

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[27] See 3.7.3.

indicating the name, title and the position of the "executive" and the total value of the payment. According to the code "executives" include the company's CEO/general director, the general coordinator, their assistants, staff directing the main units in the company organization chart and their assistants, the personnel that is directly working with the board of directors, chairman or chief executive officer/general director and other personnel such as consultants. Therefore, although the aim of this provision is to disclose the remuneration of "board members *and* executives", by considering also the related footnote, it seems that individual remuneration disclosure is only recommended for "executives", but not for the board members. For the latter, only the disclosure of the total remuneration of all board members, but not their individual remuneration seems to be enough. TCC also requires directors' remuneration to be determined either in the articles of the association or at the annual meeting.

Shareholders' rights are violated usually by these related party transactions and only the most serious cases are brought before the public prosecutor. However, the judicial period takes too much time to reach to a decision, with an average time of 18 months (Pierce & Waring Eds. p.344).

In order to response to the lack of disclosure on related-party transactions in Turkey, a new regulation has been passed in March 2008[28], Serial: IV, No:41 Communiqué on the Principles Regarding for the Joint-Stock Companies Under Capital Markets Law, requiring a listed public firm to audit its future transactions under certain circumstances and/or its frequent and pervasive transactions between the company itself and its related parties to be audited and disclosed to the public. By this regulation, the criteria of the related-party transaction are now clearly determined, with the effect that companies will be forced to consider this before realizing any intra-group transactions not only because of the costs of the auditing, but also in view of the disclosure requirements before the general meeting. The CGP include the disclosure of a detailed list regarding transactions of board members, executives and shareholders having 5 percent of the company's capital with the other group companies, including commercial and non-commercial transactions between these group

[28] For details see section 4.5.2.

companies.

According to the Communiqué of CMB on Principles Regarding Public Disclosure of Material Events (Serial: VIII, No:39), there are also numerous material events that are obligatory to be disclosed to the public by publicly held companies such as changes in the ownership and board structure of the company, direct or indirect ownership of 5 percent, 10 percent, 15 percent, 20 percent, 25 percent, 1/3, 50 percent, 2/3 or 75 percent or more of the total voting rights or capital of the corporation by a natural or legal person or any decrease in the mentioned ratios and any voting agreements that come to the knowledge of the company. Board members, CEO and other key executives and shareholders holding directly or indirectly at least 5 percent of the total voting rights or capital of the company have to disclose all transactions performed on the company shares.

In parallel to the EU Directives, CGP also recommend the companies to actively use their web site as a means of public disclosure. The Directive explicitly requires member countries to disclose the voting results of the general meeting of the companies on their web sites.[29] In the second part of the CGP of Turkey, titled Public Disclosure and Transparency, it has been recommended that the minutes of the meeting should be made available to the shareholders in writing or in electronic media at all times and list of participants and minutes of the general shareholders' meeting should be published in the company's web site. Moreover, in order to prevent any distrust on the voting results, the votes are recommended to be counted and results of voting be announced before the end of the meeting. Additionally, Article 16 of the Communiqué of CMB on Principles Regarding Public Disclosure of Material Events stipulates that ISE may request disclosure of the information from the company to be submitted via press including other types of electronic means if necessary.

The EU is also on the way of preparing a disclosure requirement for institutional investors on their investment policies and voting practices with regard to the companies they invest.

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[29] See Section 3.1.7.2.

However, this requirement does not exist in Turkey.[30]

Besides the CMB, also other institutions have a significant role in setting up standards in the accounting area. The Turkish Accounting Standards Board is a public authority which is responsible for setting and issuing accounting standards. It started its operations in 2002, translated the IFRS into Turkish and issued the Turkish Accounting Standards (TAS). According to the Draft of the new TCC, TASB will be the responsible authority to issue the TAS and coordinate the implementation among companies. Banks also apply the TAS in their accounts and reports. Additionally, TURMOB (Union of Chambers of Certified Public Accountants of Turkey) plays a role in carrying out licensing activities, organizing trainings, seminars and conferences for the accounting and auditing professions. TURMOB founded TMUDEKS (Turkish Accounting and Auditing Standards Board) in 1994 which is a member of IASC (International Accounting Standards Committee) and it has issued 15 accounting standards (www.turmob.org.tr).

4.3.5 Audit

CMB has the authority to determine the accounting and auditing requirements for publicly held companies, mutual funds, investment funds and brokerage companies.

Publicly held companies are required to have their semi-annual and annual financial reports audited by an independent audit firm. CMB approves the auditors and operates audit quality inspections of the auditors and in case of misleading activities, auditors can be held also liable. According to CMB regulations a separation of audit and consultancy activities is provided with audit firms being appointed for a maximum period of 5 years and the same audit firm can be reappointed only after two accounting periods. Hence, the rotation rule for auditors and audit firms is harmonized with the 8th Company Law Directive of EU (2006/43/EC).

The CMB performed 6 inspections in 2006 (out of 90 audit firms approved by the CMB). As it's mentioned in the Report of the World Bank on the Observance of Standards and

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[30] See Section 3.1.7.1.

Codes (ROSC) Accounting and Auditing regarding Turkey, according to the mentioned Directive all auditors should be inspected every 3 years and CMB needs to increase its capacity for inspections to meet this requirement.

The statutory audit that is responsible for auditing the company's accounts on behalf of the shareholders is not effective in practice. According to anecdotal evidences, appointment of the statutory audit in Turkey is considered as a formality to fulfill the legal obligation and is not elected carefully in professional terms (Pierce & Waring Eds. 2005, p. 345).

CMB has introduced its ISA-based standards on auditing which aims at strengthening the effectiveness of the external auditing by the Communiqué of CMB Regarding Independent Auditing Standards in the Capital Markets (Serial: X, No: 22).

In parallel to the EU regulations, also Article 25 of the Communiqé Serial:X, No:22 stipulates that, listed companies are required to establish an audit committee, comprised of at least 2 non-executives. However the independency of the members is not regulated in the related Communiqué, in contrary to the EU regulations.

4.3.6 Stakeholders Issues

The CGP have provisions (Part III, Articles 1 & 7) on the stakeholder issues, such as establishing mechanisms for participation of employees in the board and encouraging companies to be socially responsible in terms of ethical rules and the rules and laws regarding the environment, consumers and the public health. However, employee representation in the board and employee stock ownership plans are not common practices in Turkey (Tunalı et al. 2006, p. 279).

Some parts of the *acquis communautaire* cover corporate social responsibility (CSR) issues such as consumer and environmental protection (Chapters 22 and 23), the promotion of fair competition (Chapter 6) and combating corruption as a basic Copenhagen criterion (Michalel & Öhlund 2005, p. 109).

Corruption is one of the most serious problems that Turkey has to deal with as it is seen as one of the major obstacle for EU accession. EU asks the accession countries to reduce the

corruption (Michalel & Öhlund 2005, p. 109).

The Turkish government decided to approve and sign the Kyoto Protocol as of June 2nd 2008, which can be considered a great improvement in terms of the environmental responsibility aspect of CSR (Göktaş 2008).[31]

The government has also collaborated with the United Nation's Global Compact and has endorsed the ILO Declaration on the Fundamental Principles and Rights at Work (Turkey CSR Baseline Report 2008).

With this regard, the Corporate Social Responsibility Association in Turkey was established to promote CSR and build a public opinion to enrich social development. It is an independent NGO formed by the efforts from academics, businesses and other civil society organizations.[32]

4.4 IMPLEMENTATION OF CORPORATE GOVERNANCE IN TURKEY

4.4.1 Findings of Financial System Stability Report 2007 on Corporate Governance

This Financial System Stability Report (FSSR) of 2007 (IMF Country Report No. 07/361) on Turkey was prepared by IMF and the World Bank. The main findings of the FSAP on corporate governance and related subjects can be summarized as the following:

a. Although there are important improvements in regulatory reforms made especially in financial reporting, further improvements in transparency and corporate governance are needed. For instance, disclosure requirement regarding the cross holdings and the transparency of the financial reports of non-listed companies are still not in a sufficient level, while corporate ownership and corporate decision making process are often difficult to track.

[31] Turkey in fact had already completed the process of preparing to sign the protocol, however did not sign until now due to its concerns about the costs.

[32] For details, visit http://www.csrturkey.org/

b. Concerns of lack of protection of minority shareholders from the actions of controlling shareholders, the lack of quality on disclosure and the effect of controlling owners in the market may be deterring new market participation.

c. Some provisions in capital market legislation may leave room open for interpretation regarding the disclosure of material events and may result in delays in disclosure.

d. Consolidated supervision and surveillance of mixed conglomerates is another area that needs an improvement. The necessary measures must be taken in line with the EU Directive on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investments Firms in a Financial Conglomerate. Within this regard, the BRSA must adopt a policy on an integrated inspection of an entire banking group.

The report provides as a short term recommendation to review regulations in order to enable the removal of residual privileges of controlling shareholders. As a mid-term target, it is recommended to strengthen minority shareholders' protection, together with the accounting and auditing standards especially in smaller non-financial firms and raise the accountability of the board members.

4.4.2 EU Screening Report on Company Law of Turkey

According to the EU 2007 Screening Report on Turkey regarding the Chapter 6 - Company Law (p.13); Turkey's legislation has reached only a limited level of alignment to the *acquis communitaire*, both for company law and for corporate financial reporting, in particular for audit. Moreover, it has been stated that Turkey has not outlined any target dates nor plans for further approximation with the *acquis* regarding this chapter. However, the Draft TCC is currently pending before the Parliament and when it is adopted; it would address many of the shortcomings identified in this Report.

It mentions in detail some of the CGP of Turkey, TCC and CMB's regulations covering corporate governance issues such as publishing the corporate governance compliance statement, remuneration of directors, independence of directors, committees of supervisory board and international auditing standards adopted for auditing of publicly held companies and brokerage firms; and states that:

> *Turkish legislation and the CMB Communiqués issued in 2003 provide for most of the principles foreseen in the Commission's Recommendations concerning the remuneration of directors and the independence of directors and the committees of the supervisory board* (EU 2007 Screening Report on Turkey regarding the Chapter 6 - Company Law, p. 14).

It also emphasizes: "*The regulation on the rotation of auditors is harmonized with the 8th Directive of EU"*. (EU 2007 Screening Report on Turkey regarding the Chapter 6 - Company Law, p. 13).

On the other hand, the limited areas that need adjustments regarding the company law are stated as: the disclosure and publication of financial reports, certain provisions concerning the registration of branches of foreign companies, establishment of grounds for nullity, procedural aspects relating to domestic mergers and divisions, cross-border mergers, single member private limited liability companies, the recognition of the *Societas Europaea* and of the European Economic Interest Grouping and a number of aspects relating to takeover bids.

The Report states (p. 14) furthermore that disclosure requirements need to be enhanced and a general obligation to disclose financial reports needs to be introduced. However, since this Report covers the findings resulted in the explanatory and bilateral meetings on June 2006, it does not cover the amendments of the financial reporting developments as of April 2008 regarding the acceptance and implementing of the IFRS and IAS of EU. Moreover the single-member private limited liability companies and acquisition by the company of its own shares will be also introduced, together with the requirement of every company to apply IFRS if the draft of TCC passes the Parliament.

4.4.3 Report on the Observance of Standards and Codes (ROSC)

In March 2007, the World Bank issued a Report on the Observance of Standards and Codes (ROSC) on accounting and auditing in Turkey.[33] The findings of this report are similar to the findings of FSSR[34] such as the absence of related party disclosures, especially on the information regarding the transactions between group companies, intra-group assets transfers and the lack of full consolidated financial statements for the entire conglomerate.

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[33] "Report on the Observance of Standards and Codes (ROSC) on accounting and auditing in Turkey", (March 2007), accessible at: http://www.worldbank.org/ifa/rosc_aa_tur_eng.pdf.

[34] see Section 4.4.1.

In brief, the report highlights (p. 4) that international investors and credit rating agencies assess the disclosure and transparency level of the top companies of Turkey as unsatisfactory and banks do not trust the financial statements of the borrowers. There is also a lack of the knowledge on the current accounting in the companies. Financial information given by the companies is not always found reliable enough for decision-making, either.

Therefore, ROSC recommends that corporate governance measures should be modernized and in order to enhance the confidence of the transparency of the financial statements, the collective responsibility of the board must be provided not only by law but also in practice. The professionals working in the audit sector should be required to meet appropriate education, training and experience requirements in line with the Eighth EU Company Law Directive. Moreover, regulation of auditors should be reinforced by a public oversight system for the audit profession which must be governed by non-practitioners and be independent of the profession. Finally, ROSC recommended the government to play an active role in promoting the improvement of the accounting profession through a policy of the mixture of both positive incentives (e.g. education, tax credits) and deterrent incentives (e.g. corporate governance mechanisms). Implementing these accounting and auditing standards is a good model to start with. Within this regard, ROSC recommends (p. 43) rewards and incentive-based approach, together with monitoring the compliance and sanction the companies in case of non-compliance.

4.4.4 OECD Pilot Study on Corporate Governance Principles in Turkey

Turkey was the subject of a pilot study of OECD for the development of the methodology for assessing implementation of the OECD Principles and this project was conducted by OECD with the coordination of CMB in 2005 and 2006.

The assessment has resulted in the majority of the OECD Recommendations as partly implemented. Three OECD Principles have been assessed as “not implemented” (p. 30):

a. Institutional investors do not disclose corporate governance and voting policies.
b. Institutional investors do not disclose conflicts of interest in exercising their ownership rights.

c. Advice and analysis by analysts, rating agencies and brokers are not free of conflicts of interest.

In the Report the following challenges have been basically identified (pp.16-19, pp. 57-60):

a. Involvement of independent board members,
b. Shareholder participation in nomination and election of board members,
c. Control and disclosure of related party transactions and self-dealing,
d. Disclosure about boards (such as board nominees, members and work
e. procedures of board committees, remuneration),
f. Selective disclosure,
g. Exercise of ownership rights by institutional investors,
h. The protection of minority shareholders.

In detail it has been emphasized that (pp. 15-19):

a. Due to the legal restrictions for pension funds and mutual funds regarding the participation in the management of the companies they invest in and portfolio limits restricting their capacity to monitor corporate governance practices, they can not play an active role as a market discipline in the implementation of the corporate governance like in other countries. Pension funds and mutual funds are also neither required nor encouraged by the CGP to disclose their investment policies.
b. Due to the close working relationships among investment banks, brokerage and research groups, structural conflicts are arousing in many brokerage firms.
c. Abusive related party transactions occur frequently in a significant minority of publicly held companies.
d. Independent non-executive directors do almost not exist in companies' boards, as they are often current or senior managers of group companies. Senior employees of the parent company can be found in some of the group companies' boards with conflicting loyalties as being at the time employees of the holding and directors of the subsidiary. Consequently, their primary loyalty is towards the controlling shareholders, rather than to the equal treatment of shareholders and protection of the minority rights.

e. Minority shareholders have limited power to nominate and elect the directors due to the voting power of controlling shareholders unless the company implements cumulative voting process.

To meet these problems, the following basic policy options are recommended (pp. 92-110):

a. Market disciplinary forces must be strengthened by increasing the free-floating rate of the listed companies by bringing new requirements if necessary; amending the regulations regarding the mutual and pension funds which will enable them to exercise their voting rights and disclose their corporate governance and voting policies; expanding investor educations that make the investors aware of their rights and responsibilities and the way they can pursue the legal remedies to be pro-active investors.

b. Transparency of the ownership and board structures and practices should be strengthened by converting some of the disclosure principles into compulsory rules such as disclosing the entire ownership structure of the holding companies, intra-group relations and existing voting agreements. Some specific recommendations are given in enhancing the effectiveness of the transparency regarding this issue. The most important related-party transactions should require the shareholders' approval. Controlling companies can be required to compensate the loss of the controlled companies in result of exercising of control. Also, publishing "name and shame lists" of the companies which complied or did not comply with some key disclosure and corporate governance issues is also recommended.

c. A risk-based approach in regulation, supervision and enforcement should be introduced in CMB by the help of regulatory impact analysis. CMB's power of enforcement such as removing or appointing board members is recommended to be increased. Moreover, penal and administrative penalties should be deterrent enough so that the costs of the fines should overweigh the benefits of non-compliance. A new fee-structure is recommended to be introduced in CML in order to will provide the companies implementing important corporate governance measures with some fee discounts.

d. Standard setting process of financial reporting system is recommended to be centralized as well.

e. Audit oversight process must be restructured.

f. IOSCO’s Principles for Sell-Side Analyst should be introduced and fully implemented.
g. Tender Offer Communiqué should be amended.

4.4.5 Surveys on Compliance and Researches on the Implementation

4.4.5.1 ISE’s survey and an analysis on corporate governance

A survey has been conducted by Istanbul Stock Exchange (ISE) experts on the corporate governance practices of companies traded on the ISE and the member firms of the ISE in reference to the OECD Corporate Governance Principles. Afterwards, based on the findings, the relationship between corporate governance and the financial performance of these firms is analyzed (Küçükçolak & Özer 2007).

Out of the total 513 traded companies and member firms of the ISE, 358 of them have responded to the questionnaire and the findings can be summarized as follows:

Relating to the board directors;

The nomination of independent board members is not a common practice for the members and listed companies in ISE. In 56 percent of the listed firms and 59 percent of the ISE member firms, directors have executing responsibilities in other group companies of the holding; while in 62 percent of the member firms directors have other responsibilities in the company. Additionally, a kinship between the directors and controlling shareholders (38 percent for the member firms and 27 percent for the listed firms) due to the feature of the family-controlled companies in Turkey has been recognized. However, the kinship among the directors and general managers is less common (18 percent for member and 6 percent for listed firms) than the kinship between directors and the controlling shareholder. Interestingly in 18 percent of the listed firms, CEO has also responsibilities in the other group companies. The controlling shareholders decide on the appointment of the key executives due to the fact that in only 8 percent of the listed companies, appointment of executives is approved in the shareholders’ meeting. The separation of roles of the chairman of the board and the CEO is also not a common practice. Only in 10.4 percent of the listed companies the roles of chairman and CEO are separated, while this number is 12.8 percent for the member firms.

Relating to the Shareholders Rights;

In less than half of the listed companies (42%) the financial rights of the board members is performance-based. 19 percent the listed companies issued multiple shares, while 28 percent of them answered they issued preferred shares and 25 percent of them (6 percent for the member firms) restricted exercising pre-emptive rights.

Relating to the Stakeholder Relations;

Share ownership plans for the employees are not known by the both listed and member firms, the percentage of the companies that have introduced this program is only 3-4 percent (Tunalı et al. 2006, p. 287). Setting up employees' foundations and funds are also limited which is only 11 percent for the listed companies. Also, in only 29 percent of the listed companies dividends paid out to the employees.
Based on these findings, an analysis has been made and a linear relationship has been found between companies' performances and implementation of the sound corporate governance in ISE companies.

4.4.5.2 CMB's surveys and analysis of the listed companies' implementation of the CGP

CMB required all the listed companies to disclose the "corporate governance compliance statement" in their annual reports and web sites starting with the publishing of their 2004 annual reports. Later, CMB started to monitor the compliance in the following years.

CMB published a survey about listed companies' implementations of the CGP of Turkey in 2004 and the answers of 276 companies were taken into consideration. CMB reviewed and analyzed the annual reports, web-sites, disclosures, financial statements and corporate governance compliance statements in 2005 and 2006. In 2005, 248 listed companies' data was used, while for the year 2006, the review is comprised of only ISE-100 companies

which are the top listed companies in terms of market capitalization and transaction volume.[35]

Some of the important findings of these surveys and reviews are as the following:

a. In 2004, only 31 percent of the listed companies included a corporate governance compliance statement in their annual reports, while in 2005, the awareness and compliance had increased to a significant degree of 86 percent. Among them 63 percent of them gave detailed information about the implementation.

b. Issuing privileged shares is one of the major weaknesses of the corporate governance practices in Turkey. In 2004, while 21 percent of the listed companies had privileged shares regarding voting rights and this percentage has even increased to 35 in 2005. In 2004, 42 percent of the listed companies issued privilege shares on the nomination of board members, while privilege shares regarding the nomination of internal audit board was 18 percent. In 2005 the practice of the companies that issue privileged shares on profit was 19 percent . In 2006, 51 companies disclosed that they have privilege shares and 48 of them disclosed the type of the privilege in detail.

c. Both in 2004 and 2005, only 25 percent of the listed companies had a dividend policy for the shareholders and half of the companies had shareholders relations departments. Moreover, in 2004 and 2005 the percentage of companies with provisions in their articles of the association restricting the free transfer of shares was 23 percent and 25 percent respectively.

d. In 2004, 26 percent of the companies replied to have independent board members; however in 2005 this number was stated as 18 percent. In 2004, the firms had the difficulty in understanding the term "independence" and the higher percentage of statement of the companies can be explained due to this fact. Surprisingly, 36 listed companies out of 100 top-companies had independent board members in 2006. In 2004, only 4 percent of the firms had performance-based compensation for the board members, however in 2005 this percentage has shown great improvement and increased to 28 percent. Additionally, 63 percent of the listed companies disclosed

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[35] The findings of the surveys and reviews are published in the CMB's web site, accessible at: http://www.spk.gov.tr/indexcont.aspx?action=showpage&menuid=10&pid=2.

that some of their board members have other responsibilities in other group companies. The percentage of companies that established a risk management and internal control mechanisms increased from 52 percent to 77 percent, while the development of ethical rules increased from 56 percent to 74 percent in 2004 and 2005. 80 percent of the ISE-100 companies disclosed the nomination process of the directors in 2006.

e. Regarding the disclosure practices of the companies, while only 36 percent of the companies disclosed the beneficial ownership in 2004, the awareness of the companies' has been increased in 2005 and half of the companies disclosed the beneficial ownership. In 2006, out of 100 top listed companies 51 of them disclosed the beneficial ownership.

f. More than half of the companies (%56) used electronic means for the communication with the shareholders in 2005 and 77 percent had internet web-sites. In 2006, only 5 companies among the ISE-100 had no internet website of their own.

g. In 2004, only 23 percent of the listed companies made a disclosure on corporate social responsibility. In 2005, 67 percent of the listed companies disclosed that they have activities regarding the environment protection, while 51 percent of them execute activities for the public benefit and 43 percent of them contribute to the local region. In 2006, the interest on the disclosure on environmental and social issues has been increased incredibly and 92 percent of the ISE-100 companies had disclosed on this issue.

h. In 2005, some of the companies stated that not even one of their shareholder had asked any information from the company and for most of the companies the percentage of the shareholder participation to the general annual meetings is also very low. This implies to the lack of equity culture. Interestingly one of the findings was that companies inform their stakeholders more than their shareholders.

i. In 2006, the web pages of the ISE-100 companies were also examined and it was found out that 89 of them had an investor relations section on their website, 86 of them disclosed their financial reports (66 of them even provide their financial reports in English), 86 of them disclosed annual report (69 percent in English), 82 percent disclosed their articles of association, 75 percent disclosed previous general meeting

minutes, 71 percent included their corporate governance compliance report and 76 percent included their disclosure on the material events.

4.4.5.3 Other researches and analysis on corporate governance in Turkey

4.4.5.3.1 Researches regarding the effectiveness of the Turkish corporate governance system on the company level

There are different criteria or approaches that are used for measuring an effectiveness of corporate governance. *Macey (1997)* and *Gibson (2003)* suggest that focus should be more on the corporate governance outcomes, rather than the characteristics of corporate governance mechanisms, on contrary to the OECD Principles and corporate governance indices. Although there is no generally accepted criteria for assessment, *Macey* suggests three ways to measure: the premium paid by investors for voting, willingness of companies to go public and how well is the functioning of markets for corporate control (in Durukan et al 2006, p. 7). Many of the studies concentrate more on the market control. The response to poor management can be realized by the appointment of new managers through active shareholders as institutional shareholders or through takeover mechanisms (proxy fights, mergers or direct purchase of shares). Hence, the relationship between CEO turnover and corporate governance is also used in measuring the performance of the corporate governance system (Durukan et al 2006, p. 7).

Within this context a research has been made by *Durukan, Özkan* and *Dalkılıç* (2006) to assess the effectiveness of the Turkish corporate governance system by testing the CEO turnover and performance measures. The findings of this study provide evidence that the stock market return is not a significant determinant of CEO turnover and Turkish corporate governance system is not ineffective. However, it has been noted that this evidence on its own can not be generalized for the effectiveness. It has also been emphasized that the CEOs in Turkey are evaluated on the accounting based measures and this can be a reflection of Turkey being a civil law country and having concentrated ownership structures as a substitute of the market discipline (Durukan et al 2006, p.15).

Gürbüz and *Ergincan* (2005, pp. 5-7) made a study on the relationship of the performance of the ISE-30 firms and their level of corporate governance. They found out that, the more effective the companies implement the CGP of Turkey, the higher level of return on equity and the higher performance of price in the ISE they have. As the companies implement sound corporate governance, it has been examined that they have better chances to benefit from external finance alternatives, due to the increased level of confidence of creditors. Finally they found out that the listed companies in ISE-30 which have a higher free float rate implement a better level of the principles.

Churaev (2003, pp.7-8) made the same kind of study on the impacts of corporate governance practices on values of ISE-30 listed companies and found a positive correlation between the listed companies with a higher free-float rate and corporate governance implementation level.

4.4.5.3.2 Researches and case studies regarding the corporate ownership and control structure in Turkey

As already discussed above in Section 4.3.1, we will give some examples of some researches which will justify the pyramidal and cross-ownership structure and concentrated ownership of the family-owned companies in Turkey.

Kıyılar and *Belen* (2005) described the corporate ownership structure of Turkey as pyramidal structure. Families want to control the majority in a holding, while the holding company want the control the other group companies and form a pyramidal structure in Turkey. They defined the pyramidal structure as "*if there is at least one publicly held company between the company and the beneficial owner in the control chain, then the ownership of that company is defined as pyramidal structure*" (p.25).

According to a study conducted by *Demirdağ* and *Serter* (2003) on the ISE-100 companies, the controlling shareholder who controls the highest number of shares among ISE-100 companies has 45,10 percent of the shares in the company. The findings also show that 38 percent of the companies have at least one shareholder who has minimum 50 percent of the shares of the company, five biggest shareholders have the average of 64.5 percent of the

shares and 84 percent of the companies have at least five or less than five controlling shareholders who control at least 50 percent of the company shares. 58 companies out of 100 listed companies have the holding ownership; however the beneficial owner of the holding is an individual, a family or the state. The prevailing beneficial owner of the companies is the family/individual in Turkey. Families are the beneficial owners of 68 companies among 94 companies. 37 of the companies (out of 68) are controlled through pyramidal structure, where the rest is either controlled by other companies which are not publicly held or without the intermediation of another company. Families control the 52.05 percent of the shares. Holdings are the biggest shareholder in 51 companies among ISE-100. The beneficial owners of the 47 firms out of 51 companies are the families. There are 11 companies whose biggest shares are the banks and the beneficial owners of the three of them are again the families. This implies that as a control mechanism besides holdings, financial intermediaries are also used (in Kıyılar and Belen 2005, pp. 25-26).

Saraç (2002) found out that in industrial sector in Turkey, there is a greater tendency of concentrated ownership controlled by the families. He also found out that the companies that have concentrated ownership have a higher level of profit than the ones with diversified structure (in Kıyılar and Belen 2005, pp. 25-26).

In *Yurtoğlu*'s study (2003, pp. 13-14), the concentration of the ownership in the hands of a few families in Turkey is analyzed as the following:
The largest family, Koç[36], controls 15 listed companies in which their total market value accounts to almost 19 percent of the total market capitalization in Turkey. The group is run by the grandson of the founder of the holding, who took over the chairmanship from his father.

The second largest family-owned business group in Turkey is Sabancı Holding, which controls a total of 71 companies in which 10 of them are listed at the ISE with a total market value accounts to 14 percent of the total market capitalization.

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[36] Koç is a diversified conglomerate with 103 companies among them many with firm relationships to world's household names such as Ford Motor Company, Fiat, Allianz, and LG Electronics.

The third largest family, Karamehmet, controls six listed companies accounting for about 13 per cent of the market capitalization.
In total, the top five business groups in Turkey account for almost half of the total market capitalization.

4.4.5.3.3 Researches and case studies regarding corporate social responsibility

Under the regional CSR project "*Accelerating CSR practices in the new EU member states and candidate countries as a vehicle for harmonization, competitiveness, and social cohesion in the EU*" which is funded by the EC and the United Nations Development Program, the CSR Baseline Report of 2007 has been published.

In the report it has also been stated that (p. 47), there are neither very active institutional investors in Turkey as they exist mostly in Anglo-Saxon countries, nor banks like in European countries to force the companies for a more social responsible behavior. Most of the banks are also family-owned and a part of the complex structure of the conglomerates. Moreover, social responsible investment is also not well known in Turkey. Nevertheless, the government, treaties, CMB, corporate governance principles, finance institutions, multinational companies, civil society organizations and media are considered as the main driving forces for the development of CSR in Turkey.

According to the report (pp. 50-51) Moreover in the accession period, Turkey continuous harmonizing its legislation in line with the *acquis communautaire* and within this regard, in the upcoming years Turkey has to adopt its legislation in accordance with many of the EU Directives regarding public procurement, environmental protection (waste, greenhouse gas emission), social policy and employment (Child Labor Convention, European Charter), protection of consumers and free movement of capitals (such as money laundering, terrorist financing).

Finally in the Report (p. 61), the lack of the Global Reporting Initiative (GRI) and other reporting structures is mentioned as a weakness for not only the companies but also for the stakeholders of the companies who wish to monitor the company practices. Therefore,

many recommendations are given such as promoting business leadership, supporting institutions on the CSR and industry level partnerships.

Turkey has also shown a progress against corruption. According to the Transparency International Corruption Perceptions Index[37], Turkey was ranked as the 66th out of 180 countries in 2006 and 2007 and its score was 4.1 out of 10. Its score was 3.2 in 2002 and 3.5 in 2005.

Similarly, according to a study conducted by *Michael* and *Öhlund* (2005), corruption is seen as one of the most important CSR issues that Turkey has to deal with in order to become a member of the EU. The Report states that ratification of the Council of Europe Civil Law Convention on Corruption and the OECD's Convention on the Bribery of Foreign Officials in International Business Transactions by the Turkish government, issuing a 1,200 pages report by the parliamentary anti-corruption committee and investigating a number of high-level human rights are already a some steps taken in the right direction. It is furthermore recommended in the report to provide incentives for the Turkish business to respond CSR by the Turkish government and for the business to adopt CSR certifications, to introduce Triple Bottom Line Reporting, to form stakeholder board committees, engage in socially responsible investment and to undertake training on anti-corruption. NGOs' involvement is also extremely important in CSR to gain the trust of the EU countries, because according to a survey conducted in EU, it's found out that the Europeans trust NGOs more than the government, media or business organizations. Hence; it is recommended that co-operation between corporations, the government and NGOs must be established.

According to the CSR Baseline Report of 2007 (p.45), it has been stated that in the last decade more businessmen were actively involved in tackling the social problems in Turkey. They initiated various programs in Turkey in terms of CSR. The following cases are exemplary:

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[37] The index defines corruption as the abuse of public office for private gain and measures the degree to which corruption is perceived to exist among a country's public officials and politicians.

Turkcell, a mobile networking and telecommunications company, started its "*Kardelenler*" (Snowdrops) Project in 2000 to provide scholarships for female students that were in the need of financial support for their education. This project provided scholarships to 12,300 students. By the support of this project, 6,300 of students graduated from high school, out of these 6,300 students 950 made it to universities and 67 managed to get a university degree. This project is a continuing project and also supported by the media. Because of its success, it became a benchmark for CSR activity for the other companies in Turkey to support the education of the children (CSR Baseline Report 2007, p.45).

Sunjut, a textile factory, had a project of producing some part of their electrical energy by wind and this project was awarded by Eurosolar on the category of "Owner of installation using renewables" which also means the first privately owned wind power used in an industrial firm (CSR Baseline Report 2007, p.46).

Turkey's largest conglomerate, Koç, joined the UN Global Compact, agreeing to comply with principles on human rights, transparency, labor, the environment and anti-corruption (CSR Baseline Report 2007, p.44).

Aygaz, one of the Koç Group companies, disclosed its CSR reports besides its financial reports. Turkish textile industry engaged voluntarily in projects with European Civil Society Organizations such as Clean Clothes Campaign to improve the social standards in their field in Turkey (CSR Baseline Report 2007, p.46).

Ülker's programme, *10 Billion Oak Tree Campaign,* targets the environmental concerns (Michael & Öhlünd 2005, p. 2).

Moreover, NGOs like TESEV and TEDMER have organized their activities, while universities such as Sabancı and Bilkent have increasingly involved in academic debates on CSR (Michael & Öhlünd 2005, p. 2).

4.4.6 ISE Corporate Governance Index

On August 31, 2007, Istanbul Stock Exchange has launched the ISE Corporate Governance Index, a special index where only the ISE-listed companies with a minimum corporate

governance score of 6 out of 10 rated by certified rating agencies of CMB may participate. The Index is composed to measure the price and return performances of the companies that qualify the conditions and the rating is performed in line with the CGP of Turkey. The rating should be revised annually. The stocks of a company are excluded from this index in the following conditions: stocks being transferred to the Watch List Companies Market; stocks being excluded from the market permanently; the trading of the stocks is suspended; the independence of its rating agency is impaired and the its rating agency is de-listed from the list of CMB.

There are eleven companies listed in ISE Corporate Governance Index at the moment: Anadolu Efes, Doğan Yayın Holding, Vestel Elektronik, Y&Y Gayrimenkul Yatırım Ortaklığı, Tofaş Fabrika, Türk Traktör, Hürriyet Gazetecilik, Tüpraş, Şekerbank, Otokar and Dentaş Ambalaj ve Kağıt Sanayi A.Ş. There is also one non-public company, Tek Faktoring, which has a corporate governance score (www.imkb.gov.tr).

As an incentive, eligible companies which are listed in this index are entitled to a 50 percent discount on the listing fees. Since the establishment of the index, foreign ownership in listed companies has increased through both direct and portfolio investments and the number of mergers and acquisitions has also increased by the foreign investors (Ararat & Yurtoğlu 2008).

Ararat and *Yurtoğlu* (2008, pp. 74-75) suggest that there should be more requirements to be held eligible to be listed in ISE Corporate Governance Index such as minimum free float of 25 per cent, minimum of 500 shareholders, disclosure on beneficial ownership, board nominations, groups of shares and contracts with related parties.

There are two eligible rating companies that are on the list of corporate governance rating agencies list of CMB: The first eligible rating agency is Saha Kurumsal Yönetim ve Kredi Derecelendirme Hizmetleri A.Ş. which is established in Turkey, while ISS (Institutional Shareholder Services) Corporate Services, Inc. is the second eligible rating agency which is established under Risk Metrics Group Inc. and is licensed by the CMB to provide corporate governance ratings in Turkey. Standards and Poor's Corp., Moody's Investor Service Inc.

and Fitch Ratings Ltd. are approved by the CMB to engage in credit rating activities in Turkey. Core Rating is no longer in the list of licensed corporate governance rating agencies of CMB of Turkey.

4.4.7 Corporate Governance Reports and Surveys by International Rating Agencies

According to a recent survey on Turkish Transparency and Disclosure which is conducted by S & P and the Corporate Governance Forum of Turkey (2007), disclosure continues to be improved while the overall pace of improvement has slowed down after 2003. According to the Survey of 2007, the top five companies in terms of transparency and disclosure (in alphabetical order) are: Akbank, Anadolu Efes Biracilik ve Malt Sanayi, Enka Insaat ve Sanayi, Koc Holding and Turkcell Iletisim Hizmetleri. Four of the companies (Akbank, Anadolu Efes, Koç Holidng and Turkcell) were also ranked as the top five companies in 2005 and 2006 (Balic & Ararat 2007).

According to the survey, the weakest disclosure area is the remuneration of directors and executives and the highest disclosure is found in disclosure on financial information due to the mandatory disclosure requirement of CMB. Also, companies continue to be reluctant to disclose the top ten shareholders, any formal or informal voting agreements or blocks between major shareholders, shareholders' agreement between different classes of shares and the nomination process. Moreover, although many executives in the holdings have a responsibility on the subsidiaries of the holding, there is no disclosure on such practices, either. Nevertheless, more companies disclose their articles of association on their websites (Balic & Ararat 2007).

Fitch Ratings has also published a Report on the corporate governance issues in Turkey in 2007. In this report, especially in the areas of board quality, related-party transactions and ownership structure and protection of minority rights, Fitch examined some weaknesses in terms of disclosure. Although companies are now disclosing more about their beneficial ownership, and major shareholders, due to their complex legal structures, it is hard to track the identity and the size of the beneficial ownership. Moreover, disguised asset or profit transfers within a complex group structure are probable and seen as a problem in Turkey. In addition, it has been found that very few companies disclose detailed information on board

and executive remuneration. The level of board independence in the Turkish system still remains inadequate.

4.5 RECENT DEVELOPMENTS IN CORPORATE GOVERNANCE

4.5.1 The Draft Turkish Commercial Code

The present Turkish Commercial Code (TCC) was adopted in 1957 and since then, for more than half a century, it has remained in effect only with minor and insignificant changes. However, due to the economic developments, global competition, new legal needs, requirements for Turkey's integration to the EU in term of harmonizing commercial regulations in line with *acquis communautaire*, the TCC needed of be revised in order to better respond to the new challenges and needs.

After a long preparation for the amendments, the draft TCC is now before the Parliament. The Draft contains many reform provisions regarding corporate governance. The major and significant reforms in the Draft Code regarding corporate governance can be summarized as the following (OECD's pilot study 2006, pp. 50-53; Price Water House 2008; Yüksel 2008, pp. 107-109):

1) In the Draft the corporate governance approach relies on four principles: transparency, fairness, accountability and responsibility. Transparency is required in individual corporations' and corporate groups' financial reports, annual reports and independent audit report. Fairness provides a balance among all the stakeholders and brings objectivity. Accountability is required in the flow of information, reports of the board members. Responsibility is regulated in parallel to accountability.

2) The Draft recognizes CMB as the sole authority for the adoption of the Corporate Governance Principles.

3) The Draft requires listed companies to publish an annual corporate governance statement in which their compliance with corporate governance rules is assessed.

4) All the companies whether publicly held or not, will have to prepare their financial reports in line with the Turkish Accounting Standards (TAS), the translated version of the

IFRS by TASB, approved by the International Accounting Standards Board. This is already a mandatory requirement for publicly held companies.

5) All listed and non-listed liability companies will be required to have independent audit. International auditing standards will be applied for the independent auditors. Small sized companies may be supervised by a minimum of two independent sworn-in auditors or a certified public accountant and a financial advisor. On the other hand, the requirement to have statutory auditors among the statutory bodies of joint stock corporations is abolished.

6) Audit firms will be subject to regular rotation every five years. This is already obligatory according to the CMB Communiqués.

7) Audit firms will not be permitted to give legal or financial consulting to companies which they audit. This is already obligatory according to the CMB Communiqués.

8) Shares with privileged voting rights will be recognized, however they will be subject to restrictions. It limits the number of votes per privileged share to 15.

9) The Draft requires every company to have a website of their own. On their websites, companies will publish company disclosures; all announcements and invitations pertaining to general assemblies; all reports concerning the company such as audit report, rating report and financial statements; proxy instructions; all the information that is concerning minority shareholders, creditors and stakeholders. The website introduced the term “stakeholder” in TCC. By this provision, people will have easy access to previously unavailable company information. Moreover, in case of publishing false information on the website, the company will face legal and criminal liability.

10) Joint stock corporations will be allowed to hold on-line general assembly meetings so that on-line attendance for general assembly meetings will be possible for the shareholders. On-line meetings will be available also for the board members. In addition to this, all the administrative formalities for the meetings can also be conducted on-line. This provision will not only increase the participation of the shareholders to the general meetings, but also will enhance the transparency.

11) Electronic voting will also be possible. Decisions made via on-line meetings will be deemed valid and it will be possible to record the decisions with secure electronic signatures or physical signatures appended afterwards.

12) According to the Draft, a joint stock corporation or a limited liability corporation can be established with only one shareholder.

13) The rights of the minority shareholders' are diversified such as squeeze out right, asking for special investigation in case of abuse of control by the controlling company.

14) The representation of the minority shareholders or the shareholder groups will be enabled.

15) The Draft Code introduces the concept of "company groups" which is defined as a corporation, directly or indirectly, controls the majority of voting rights, or is in a position to vote for the election of enough board members to provide the majority in the board, or exercises the majority of the voting rights by himself or with other shareholders under a contract, or keeps another corporation under control by virtue of a contract or by another mean. The Draft includes many provisions which enhance transparency of intra-group relations; restrict opportunities for abuse of controlled companies' minority shareholders and prohibit controlling company from abusing its power to control the affiliates. The parent company's board will have the responsibility to prepare a report regarding all its transactions with the controlling company and with other affiliates; any actions taken or not taken for the benefit of the parent company or other affiliates and any losses incurred by the controlled company as a result of such transactions or actions. Directors can be held civilly liable and the company itself can be prosecuted in case of a failure of the preparation of the report.

16) Cross-shareholding will still be valid; however a controlled company that have a cross-shareholding in a controlling company would only be permitted to exercise 25 percent of the voting, dividend and other rights attaching to that cross-shareholding.

17) The board's duty to monitor the management, dismiss executives, publish the company's corporate governance statement, determine the principles of financial reporting and organize the general meeting can not be delegated and considered as reserved powers.

4.5.2 The Recent Regulations of CMB

The Communiqué Serial: IV, No: 41 regarding the Principles for the Joint-Stock Companies under Capital Markets Law has recently come into force (March 19, 2008). According to this Communiqué, three important requirements have been introduced for publicly held listed companies:

1) Auditing and disclosing of related party-transactions: If the listed company anticipates that the amount of each transaction between the company itself and the related parties, regarding assets, service or debt transfers will be or above the 10 percent of the total assets or total gross sales of the company according to the last annual financial tables, these transactions should be audited beforehand. The board of the directors shall decide on the conditions of these transactions and the independent audit firm shall give its opinion whether these conditions are fair and reasonable and submit its report to the board. Afterwards, board of the listed company decides on whether to perform or not these transactions. In case of performing the related party transactions, the type of the relationship of the parties and the transactions itself, assumptions of the assessment and the summary of the audit firm's report and the reasons for the non-compliance of the conclusions of the audit report should be provided for the shareholders 15 days before the general shareholders meeting to be examined. Furthermore shareholders should be informed at the general meeting. CMB may oblige the non-listed public companies to audit its related party transactions. The same procedure is also followed in case of frequent and pervasive related party transactions which are defined as commercial or non-commercial transactions realized or to be realized at least twice in a fiscal period between listed companies and its related parties.

2) Establishment of Shareholder Relations Department: In order to improve the relations between shareholders and the board of the listed company and to facilitate the exercising the shareholders' statutory rights, a new department which is called as "shareholders relations department" must be established in the listed companies which will

be directly responsible to the board. This provision was actually included in the CGP of Turkey and implementation was voluntarily, however by this Communiqué it became mandatory. The so-called department will be responsible from the activities such as keeping proper, secure and up-to-date records of shareholders; responding to the shareholders' written queries for information regarding the company; preparing the documents to be used by the shareholders in the general shareholders' meeting; ensuring that the general meeting is conducted in accordance with the legislation, the Articles of the Association and other in-house regulations; supervision and surveillance of all issues concerning public disclosure and keeping the records of voting results and ensuring that all reports related to the resolutions of the general meeting are sent to the shareholders. The name of the manager of the department and his/her contact information and any changes in the name and the contact details should be disclosed to the public via the Bulletin of ISE.

3) The Enhancement of the Capacity of the Listed Companies' Compliance with the Capital Markets Legislation: By the above mentioned Communiqué, listed companies are required to appoint a full-time working executive who will be responsible for both the compliance of the company with the capital market regulations and the coordination of corporate governance practices. This manager will directly report to the top executive manager. This appointed manager should have the License for Advanced Level of Capital Markets Activities and License for Corporate Governance Rating Specialist. The name of the manager and his/her contact information and any changes in the name and the contact details should be disclosed to the public via the Bulletin of ISE.

Finally, as mentioned in the Section 4.3.4, according to the new Communiqué enacted in April 2008, all the listed companies, intermediaries and portfolio management companies will apply the original IFRS and IAS as recognized and applied by EU. TASB's translation of IFRS/IAS will be taken as a benchmark, which is also in line with the related provisions Draft of TCC. By this development, divergences of the previous IFRS-based standards of Turkey have been eliminated.

Moreover, in June 2006, the CMB issued the Communiqué (Serial:X, No:22) on Independent Auditing Standards which is in line with International Standards of Audit set by the International Federation of Accountants. Exam requirements for the auditors are

being introduced in order to fill the gap of knowledge of the auditors on IFRS, IAS and ISA.

5. CONCLUSION AND RECOMMENDATIONS

Today, both the developed and developing countries are aware of the importance of corporate governance for the well-functioning of the financial markets (more stability in the stock market and currency) and the economic development (increased foreign capital investment, efficient allocation of resources, greater level of mergers and acquisition, active stock market) as it has already been scientifically proved.

Additionally, surveys also show that (foreign) institutional investors take into consideration the level of transparency and the existence of sound corporate governance while making their decisions to invest in a (foreign) market. At the company level, empirical studies have proved that there is a link between corporate governance and some financial indicators such as operating/financial performance and market valuation; lower costs; higher returns of assets and growth; greater access to external capital and lower risks of fraud and corruption (Chapter 2).

We can differentiate basically between two different types of corporate governance models: The "outsider model" which is shareholder-oriented and mainly used by Anglo-American countries, such as US, UK and Ireland and the "insider model" which is stakeholder-oriented and is more broadly used by Continental Europe, Japan, many Asian countries and most of the emerging market countries. The "insider model" comprises of the Germanic model (used by Germany, Austria, Switzerland, Netherlands and some of the Scandinavian countries), the family/state based model (such as Italy, France, Greece and Denmark) and the Japan-based model. Turkey's corporate governance structure can be categorized as an "insider model" structure (family/state-based) due to the characteristics of concentrated ownership, relation-based network, weak capital markets, pyramidal structures and multiple shares.

It can be concluded that there is no "one-size-fits-all" type of corporate governance model that suits every country and company. It is therefore up to each country to select its own model and related mechanisms according to its specific needs and conditions. This is one of the main reasons why the EU decided not to develop a binding single EU corporate governance code for its member states.

Historically, the European Commission corporate governance concept is based on a social model. One of the pillars of the EU's Lisbon Agenda is "social inclusion" besides "economical competition" and "environmental protection". In most of the EU countries, employee representation in the boards is common. The predominant "insider model" which is privileged by most of the countries of Continental Europe including its "social" features concerning primarily stakeholders protection, can be seen as founded in the "civil law system".

Although the EU's corporate governance "policy" seems to have been set as a "social" one, a tendency among EU member states to integrate elements of the "outsider model" concept can not be ignored. This can generally be explained by the increased need of all countries to stay competitive in a globalized world with integrated markets, resulting in a stronger convergence of models and approaches. Multinational companies as the drivers of globalization and at the same time as its product, foster this convergence in the world.

For instance, the number of European companies that are listing on NYSE or LSE has increased. The local listing requirements result in the adoption of the US corporate governance approach with the effect of company reforms focusing on more shareholder protection. Even at the supranational level, the approach has shifted from strict harmonization to a market-regulated and market-based system providing the flexibility of choosing the "right" model, regulatory competitiveness and mutual recognition of the corporate governance models. The experts groups such as "The Group of High Level Company Law Experts", and the "Committee of Wise Men on the Regulation of European Securities Markets", play a predominant role and can be seen as the driving force in the process of changing the approach of the European Commission with regard to the regulatory framework for company law and corporate governance in the EU.

A whole set of reforms has been put on the way with the "2003 Action Plan on Modernizing Company Law and Enhancing Corporate Governance". It set out new strategies and initiatives for the short and medium term and implemented through either Recommendations or Directives concerning for example shareholder rights, the disclosure of board remuneration, the requirement of independent non-executive directors, and the composition of the board committees. Surveys and studies show that there is a tendency of convergence among EU members in the areas of regulatory reforms in line with the EC's

regulations; however there is a divergence in practices, methods and mechanisms used due to the differences in the national history of economical developments, the national attitudes and traditions and the different origins of national legal systems and actors in the financial system. Therefore, even though the same elements of the common governance model are used within most of the EU member states, the outcomes differ among them. Finally, it can be concluded that the enhancement of corporate governance in the EU is an on-going process and can only be successful if realized on common grounds by “soft” harmonization leaving some flexibility to the member states (Chapter 3).

In this regard, although Turkey’s corporate governance system has some similarities with the characteristics of the corporate governance system of the EU (like comply or explain approach, principle-based regulation, ownership concentration, civil law, pyramidal structures, multiple-shares), it has also many divergence elements deriving mainly from the economical policies used for the development of the economy, the traditions and business culture and the different legal aspects.

Similar to some countries of Europe, Turkey’s business is from a structural point of view also comprised of concentrated ownership mainly in the hands of a few families. However, these family-owned companies are not predominantly privately held companies like it is the case in the EU, but are also including publicly held (family-owned) companies with a lower floating rate than the EU average. Turkey’s financial system is mostly bank-oriented and capital markets are less-developed like Germany, however banks and insurance companies do not play an active role in the corporate governance system in Turkey as they do in Germany. Actually, institutional investors such as mutual and pension funds are restricted to portfolio limits and participation in the management of the companies they invest in. Due to these legal constraints, the shareholder activism (as a very common practice especially in UK) and socially responsible investments (seen mostly in the Netherlands, UK, Belgium, Sweden, Italy and Spain) are unknown to Turkey. Moreover, while preparing the corporate governance principles in Turkey, not only the European countries’ best practices but also US regulations and practices were taken into consideration. Therefore, Turkey’s corporate governance system includes most of the elements of the “insider model”, however still carries its own country specific characteristics with a harmonization of Anglo-American and Continental Europe mechanisms.

As a conclusion it can be stated that Turkey needs some further improvements in some areas of corporate governance. On the other hand, it must be emphasized that the major steps and reforms that have been taken so far are considerably successful, especially in terms of regulatory reforms. Even though the corporate governance principles have been introduced only five years ago, their perception and adoption by companies have been noticeably increased. Some of the principles are included in the CMB's regulations and corporate governance practices are monitored continuously by the CMB. The most important strength of Turkey is the recognition and application of the IFRS/IAS which are applied by the EU. Its ISA-based standards; new reforms regarding the obligatory auditing and disclosure of related party transactions; mandatory establishment of shareholders' relation department and disclosure of corporate governance compliance report in the annual report and web sites are crucial for the development of sound corporate governance. Moreover, after the draft of the TCC will be enacted, the majority of the weaknesses that are stated and criticized by the international rating agencies or the institutions or organizations such as OECD, IMF, World Bank or EC will be eliminated (Chapter 4).

Nevertheless, in view of Turkey's status as a Candidate Country to European Union membership and with regard to a (future) implementation of EU Recommendations and Directives in this field, the following issues have to be considered to be regulated or amended by the regulatory institutions of Turkey:

1) **Facilitation of proxy voting**: According to the EC's Directive on Shareholders' Rights, the existing constraints of the member states on the eligibility of proxy holders and the excessive formal requirements for the appointment of them have been abolished. Therefore, provisions in TCC and CMB's Communiqués regarding the share blocking by the custodian before the general meeting and formal requirements for the appointment of proxy holders should be eliminated accordingly.

2) **Introduction of electronic voting/ participation; minimum notice period**: The EC's Directive on Shareholders' Rights ensures that shareholders of listed companies have timely access to the accurate information before the general meetings to vote at distance by electronic means (minimum notice period of 21 days for most general meetings, which can be reduced to 14 days where shareholders can vote by electronic means). Electronic voting and using electronic means in general meetings have already been regulated in the Draft of

TCC. However the technical mechanisms and the implementation should be debated and decided by the related governmental institutions. Moreover, although the Corporate Governance Principles of Turkey recommend a minimum notice period of 21 days, the current TCC provides only 15 days. The minimum notice periods regulated by EC should be taken into consideration by the Draft of TCC.

3) **Establishment of separate remuneration and nomination committees**: The Recommendation of EC identifies three areas of conflict of interests which are the nomination of directors, their remuneration and the audit. Hence, it encourages the creation of nomination, remuneration and audit committees with a majority of their members being independent directors. However, in Turkey it is mandatory to establish only audit committee composed of at least two non-executive directors. Neither the Communiqué nor the CGP covers the requirement/recommendation of independent board members in this committee. Moreover, in CGP it is recommended to have a corporate governance committee which covers more or less the roles of the remuneration and nomination committees. However, with regard to the identification of the areas of conflicts of interest by the EC, it would be better for Turkey to establish two separate committees (nomination and remuneration) within the board, with a majority of independent members.

4) **Requirement of independent board members**: According to the Recommendation of EU, the boards should have a sufficient number of independent members. Criteria for independency for board members are determined in CGP in detail. Moreover, CGP of Turkey recommends at least one-third of the board of the listed companies (not less than two members) to be composed of independent board members as well. If the independence criteria would be fixed by CMB in the related Communiqué and if listed companies were required to have independent board members as it is already obligatory for the real estate investment trusts, boards would be able to work (more) independently from the controlling shareholders.

5) **Clarification concerning disclosure of individual remuneration of board members**: Individual board member remuneration disclosure is recommended by the EU recommendations. CGP of Turkey also recommends the companies to disclose the remuneration, bonuses and other benefits of the board members and executives together with the criteria in determining the compensation in the company's annual report. As

mentioned above in Section 4.3.4. due to the inaccurate wording and structuring of the principles of disclosure of individual remuneration of board members in the Corporate Governance Principles of Turkey, the disclosure principle of individual remuneration of board members as well as executives remains unclear and should therefore be explicitly recommended in the CGP of Turkey with a clear wording not to lead to any misunderstanding.

6) **Separation of the role of the CEO and the Chairman of the Board**: In the Recommendation of EC, separation of the role of the CEO and the chairman of the board must be provided. According to the surveys conducted in Turkey, this implementation is rather weak although the separation is recommended in the CGP of Turkey. CMB should therefore either reconsider whether to transfer this recommendation to its regulations in order to enable the board perform its oversight efficiently or, in case of the concentration of both powers in one person, require at least disclosure of additional safeguards as some of the EU countries already did.

7) **Control of Auditors**: According to the 8th Company Law Directive of EU all auditors should be inspected every three years and CMB needs to increase its capacity for inspections to meet this requirement.

Turkey as a candidate country should harmonize its existing regulations in accordance with the Directives and Recommendations of EC; however regulation is not enough if it is not enforced well. As we have examined in Section 2.3.1., investors wanting to invest in an emerging country primarily consider the level of enforceability of legal rights in that country. Therefore, in order to enhance the companies' implementation and the effectiveness of the implementation of corporate governance principles in general, the following future priorities should be taken into consideration by the policy makers and the market participants in Turkey:

1) **Improved Government policies**: Economical policies and the type of the strategies of the Government shape the quality and effectiveness of the corporate governance system. The openness to foreign investments and foreign ownership, formation of the liberal financial markets, replacement of the state dominance with the competitive market economy, privatization, de-regulation and proper balance of regulations do all matter for

the better institutional adjustment of Turkey. The better functioning of the Government, the better functioning of the business which will help to establish a sound corporate governance.

2) **Development of a private equity culture**: The most important duty of the policy makers and the business is to help to develop the equity culture in Turkey. By both the mandatory regulations and voluntarily principles, companies are forced or motivated to apply these principles. Although the core aim of all these efforts is to protect the shareholders rights, there is no shareholder culture in Turkey and NGO culture is newly developing. Therefore investor education should be fostered not only by governmental institutions or self-regulatory organizations such as CMB and ISE, but also by NGOs, forums, universities, business associations and civil society organizations such as the Corporate Governance Association of Turkey, the Corporate Governance Forum of Turkey and TUSIAD.

3) **Training of (independent) board members**: In order to promote independent board members and enhance the awareness of the CEOs on corporate governance issues, the education programs that are already given by the Corporate Governance Association of Turkey and Corporate Governance Forum of Turkey should also include the formation of qualified and independent board members and CEO. Independent directors associations can also be established.

4) **Monitoring through media and presentation of awards**: Good media coverage on companies' strong or weak corporate governance performance could be a driving factor for market discipline. Awards can be organized for the companies that implement sound corporate governance and their performance compared to the past must be clearly shown and disclosed to the public in order to create an awareness of benefits of the corporate governance.

5) **Incentive-based regulations**: Incentive-based regulations to support the implementation of corporate governance should be on the agenda of the policy-makers. For instance, tax exemptions in selling the cross-shares could be introduced like it is the case in Germany and Italy. To facilitate legal requirements in order to file legal actions by shareholders on behalf of the company for damages caused by board members, the threshold of

shareholders to file a suit could be reduced, settlement agreements should be disclosed to the public and a more favorable regime on lawyers' fees for the plaintiff shareholders could be introduced similar to German's derivative lawsuit procedures (See Section 3.2.1.4).

6) **Enhancement of some disclosure areas:** The information on beneficial shareholders, intra-group ownership and control structures, board nomination process, remuneration of directors and executives, any formal or informal voting agreements or blocks between major shareholders, shareholders' agreement between different classes of shares, inter-locking board responsibilities and related-party transactions are the areas of disclosure to be improved. The disclosure of these areas can be enhanced either enforcing them by law as it is recommended by OECD; or by making the related disclosure one of the requirements to be listed in the ISE Corporate Governance Index as suggested by *Ararat* and *Yurtoğlu*.

7) **Removal of legal restrictions for institutional investors:** Institutional investors are the major driving forces of monitoring the corporate governance practices of the companies. Pension funds and mutual funds cannot actively participate in the development of corporate governance as a market disciplinary force, due to the portfolio restrictions and legal constraints on exercising voting rights and the active participation in the management of the companies that they invest in. Therefore these restrictions should also be eliminated as it is also recommended by OECD.

8) **Establishment of shareholder activism**: Shareholder activism is inexistent in Turkey. Pension funds, mutual funds and hedge funds in US, UK, Germany, Netherlands and Sweden have become very active in engaging different types of shareholder activism methods to pressure the boards and the managers of the firms to enhance the firm value and the governance effectiveness. The role of the institutional investors in Turkey should be enhanced in corporate governance in order to compete with the other international institutional investors.

9) **Introduction of socially responsible investments and Triple Bottom Line Reporting regarding CSR**: Socially responsible investment funds are unknown in Turkey. These funds that exist in most of the EU countries have a potential to help change corporate governance practices of the companies by screening the corporate governance practices of

the companies and investing accordingly by also taking into consideration the social, ethical and environmental attitudes and practices of the companies. They actively use their shareholder rights to force the companies to be socially responsible. The awareness of corporate social responsibility is also increasing in Turkey. The next step of the initiatives for CMB could be introducing the triple bottom line reporting for listed companies.

10) **Establishment of corporate governance expert committee**: The assessments and the policy options of the OECD's Pilot Study on Corporate Governance in Turkey (2006) are a very important guide mainly for CMB and other policy makers. A committee or a commission composed of academicians, business experts and private sector representatives could be established to discuss the findings of this report and advice the CMB on the short/middle and long term initiatives and methods to follow.

As a conclusion we can state that, within the last decade the approach of the European Union on corporate governance has undergone a constant development resulting in a number of recommendations and regulations with a shift from corporate governance being considered to be solely a part of national company law of the member countries to a consideration of also being a separate interdisciplinary area to be dealt with at the EU level. Corporate governance should not be considered as a work of routine harmonization process, but should rather be perceived as the approaching of the standards of the member states to a higher level to achieve the Lisbon Agenda goal which is the European Union "to be the most dynamic and competitive knowledge-based economy in the world". The addition of shareholder protection elements to the EU's social model will already make the EU unique and competitive in this area.

The implementation of Corporate Governance in Turkey on the other hand, can be enhanced not only by adopting rules, regulations and principles on paper, but also by giving some incentives, creating market-based disciplinary mechanisms and raising the awareness of the companies to effectively apply them as an everyday practice of a business behavior. Corporate governance, on the one hand will help to improve the Turkish economy in terms of sustainable development and growth and stimulate the foreign investments which will enhance Turkey's competitiveness, and on the other hand, will foster the accession of Turkey to become a full member of the EU by approaching the EU standards.

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