

Corporate governance in Turkey: an overview and some policy recommendations

Melsa Ararat and Mehmet Ugur

Mehmet Ugur is the Jean Monnet Chair in the political economy of European integration and co-ordinator of the MA program in European public policy, at the University of Greenwich, London. His research work focuses on globalization and regional integration, corporate governance in Europe and E.U. Turkey relations. Among his publications, *The European Union and Turkey: An Anchor/Credibility Dilemma* was published by Ashgate in 1999. *An Open Economy Macroeconomics Reader* was published in 2002 by Routledge.
E-mail: M.Ugur@gre.ac.uk

Melsa Ararat is Director of Corporate Governance Program, a joint initiative of Sabanci University (Istanbul) and TUSAD (Turkish Industrialists and Businessmen Association), visiting faculty member of Graduate School of Management of Sabanci University. She has vast amount of international experience in boards and senior management positions. Her work is divided between academic activities and activist work in corporate governance and corporate social responsibility.
E-mail: melsaararat@sabanciuniv.edu

Abstract Both international and domestic developments have combined to bring the corporate governance (CG) debate to the fore in Turkey. Given this increased interest in CG matters and the significance of Turkey as an emerging market, we provide an overview of the Turkish CG framework with two objectives in mind: (i) contributing to the growing CG literature by presenting the main aspects of the CG practice in Turkey, and (ii) locating the Turkish CG reform agenda within the global debate – especially as it relates to the practice in emerging markets. We begin with a review of the CG debate as it relates to emerging markets. We then provide an account of the socio-economic environment within which the Turkish CG debate is unfolding. This is followed by an examination of the external (market-related) and internal (firm-related) dimensions of the Turkish CG framework. Finally, we summarize the main findings and offer some recommendations for a successful reform initiative in Turkey.

Keywords Corporate governance, Disclosure, Foreign investment, Turkey

Introduction

Both international and domestic developments have combined to bring the corporate governance (CG) debate to the fore in Turkey. On one hand, the CG debate at the international level had a “pull” effect. It has drawn the attention of Turkish companies and policy-makers to the linkage between CG quality and sustainable development. On the other hand, domestic realities such as limited foreign direct investment (FDI), limited and highly volatile external portfolio investment, restructuring of the banking system, and the possible drying up of “easy credits” from public or group banks, etc. had a “push” effect. These developments and the crisis-prone macroeconomic environment have induced Turkish companies and policy-makers to start questioning the current corporate governance practice in Turkey.

Given the increased interest in CG matters and the significance of Turkey as an emerging market, we provide an overview of the Turkish CG framework with a view to achieve two objectives. First, we aim to contribute to the growing literature by highlighting the main features of the CG practice in Turkey. Secondly, we aim to locate

the CG debate in Turkey within the global debate – especially as it relates to CG practice in emerging markets. The second objective is informed by the need to develop a comparative perspective and avoid the oversights that may hamper the success of CG reforms.

The article is organized in four sections. The first section presents a brief overview of the CG debate as it relates to emerging markets. In this section, we introduce the CG concept and examine the causes and expected consequences of CG reforms in developing countries. The second section provides an account of the socio-economic environment within which the Turkish CG debate is unfolding. This section can be seen as a building block for section three, where the main features of Turkey's CG framework is placed under the spotlight. In section three, we examine the external (market-related) and internal (firm-related) dimensions of the CG framework, and identify the need/scope for change. Finally section four summarizes the main findings and offers some recommendations for a successful reform initiative.

Corporate governance: definition, issues and reform

As a concept, corporate governance (CG) has acquired unprecedented significance in the global policy debate on sustainable development and the role of business organizations in that process. Like many significant issues, however, agreement on what constitutes CG is still elusive. Aware of this state of affairs, we subscribe to a broad definition that captures the corporation's interaction with "internal" as well as "external" stakeholders. In this paper, CG refers to a set of rules/institutions/practices that minimizes the agency cost and the divergence between social and private returns on corporate activity (Monks and Minow, 1996).

The original need for an effective CG framework stems partly from the separation of ownership and control in publicly held companies. CG issues are intrinsically linked to the "principal-agent problem", which exists because managers (i.e. the agents), in the absence of perfect information and effective sanctions, can thwart shareholders (i.e. principal) and pursue their own goals (Berle and Means, 1932). These goals may well be conducive to over-investment and unsustainable growth in pursuit of power and prestige (Jensen, 1986). An effective CG framework is also necessary to ensure a level playing field for corporations and discipline the behavior of the company insiders vis-à-vis stakeholders in general. These objectives can be achieved by putting in place standards, transparency requirements and monitoring and compliance mechanisms that corporations must adhere to (World Bank Group, 1999).

In less developed markets, where institutions are weak and ownership is concentrated, corporate governance issues go much beyond agency problems. The controlling shareholder generally takes an active interest in running the company and holds executive roles. Minority shareholders and other investors may be constantly confronted with acts reflecting lack of property rights, contract violations, transfer pricing, targeted issues and repurchases, self-dealing, asset stripping and abuse of minority positions, etc. which remain unpunished. The dominant conflict observed in less developed markets between the dominant shareholders/managers and other stakeholders, especially the outside investors and creditors, is referred to as the "expropriation problem".

CG reforms in emerging economies are driven by increasing need for extra-firm sources of capital in a period of globalization. Firms need higher investment levels to compete in global markets. This requirement is further exacerbated by the fact that national development banks traditionally financing enterprises through public

borrowing and high inflation are no longer sustainable. Reforms are also demanded by portfolio investors who have detected some decoupling of emerging market performance from developed markets.

Despite the potential for a virtuous circle involving CG reforms in an increased equity investment flows to developing countries, the actual trends have proved less than satisfactory. On one hand, governance reforms in emerging markets have not progressed sufficiently. On the other, the investors' appetite for risk in emerging markets proved to be an over-simplification (Clark, 1998). The net private equity flow to emerging markets has fallen from \$51.9 billion in 1993 to a negative \$1.7 billion in 2001 (Institute of International Finance Web-site, www.iif.com, 30 January, 2002). Although the forecast for 2002 is positive, the reversal maybe slow – reflecting the low levels of net inflows in late 1990s. In addition, developing countries trailed behind their developed counterparts, whose share of total foreign investment (equity plus FDI) has continuously increased from less than 60 percent in 1998 to over 80 percent in 2000 (UNCTAD, 2001).

Only recently, following the corporate scandals in developed markets (Enron, WorldCom, etc.), that emerging markets are reappearing on investors' radar. Higher growth and increased profitability, accompanied with improved corporate governance standards may attract investors disappointed by the downfall of the US and European markets. It is yet to be seen whether this trend will continue if and when US and European stock markets regain investor confidence and start to recover. Until then, emerging markets have a window of opportunity to increase their share of international portfolio investment flows.

CG reforms to date have largely involved promotion of best practice codes and assume the existence of efficient legal and regulatory framework and empowered capital market regulators capable of enforcing the rules. This reform effort (inspired by the 1998 OECD framework) has been based on the belief that businesses have enough incentives to self regulate and that corporate level initiatives would trigger supplementary legal and regulatory reforms. Nevertheless, the optimism underpinning this approach started to falter for a number of reasons. First of all, not all firms have been enthusiastic about adapting the prescribed codes. In fact, aggressive competition on CG quality has become a frequent means of "stealing" a comparative advantage in increasingly competitive markets for goods and services. Secondly, in most developing countries the reform process has been difficult and slower than expected due to the complexity and path dependency of the economic, social and legal structures (Bebchuk and Roe, 1999). As Oman (2001) notes, oligopolistic coalitions who frequently operate as corporate insiders in developing countries, cling to politically endorsed privileges and hamper the introduction of accountability and transparency reforms. Thirdly, law enforcement in most developing countries is compromised by the fact that the courts are under-financed, under-resourced, and lack the necessary expertise. There has been an increasing awareness that the focus on primacy of boards and firm level compliance with best practice codes may not be sufficient to affect the way the corporations are governed and transplantation of OECD principles will not change the corporate behavior (see Allen, 2000 for a discussion in Asian context). This is confirmed by a recent progress report on assessments of corporate governance in 15 countries released by the World Bank (World Bank Group, 2002). Using OECD guidelines as benchmark, the report states that the legal and regulatory frameworks of the assessed countries may be largely compatible with OECD principles, but compliance in practice remains an elusive task.

A parallel conclusion can be derived from McKinsey's 2001 Emerging Market Investor Opinion Survey. The survey results indicate that institutional investors rate the enforceability of legal rights as the most important *external* factor of the CG framework when selecting emerging market countries for investment. This is followed by the quality of economic management, independence of judiciary/quality of legal system, and the level of corruption (see Table I). The survey results also highlight the need to work on the internal dimension of the CG framework – especially the dominance of family ownership. Investors participating in the McKinsey survey rate the distinction between company and family interests as the most important corporate-level factor in selecting the companies in which to invest, followed by clearly defined governance arrangements, accuracy of financial reporting, legally enforceable minority shareholder protection and the use of performance-based pay for top management.

Most important challenges faced by the corporate governance reforms in developing and emerging economies are establishing a rule-based system of governance (as opposed to a relationship-based), combating vested interests, dismantling pyramid ownership structures, severing links such as cross shareholdings between banks and corporations, establishing property rights that clearly and easily identify true owners, protecting and enforcing minority shareholder rights, preventing asset stripping, promoting good governance within concentrated and family-owned ownership structures and cultivating technical and professional know-how (CIPE, 2002).

Despite observed reluctance and difficulties, there may be significant incentives for individual firms to differentiate themselves by voluntary measures. For example, the Credit Lyonnais Securities Asia (CLSA)'s report on corporate governance ranks 495 firms across 25 emerging markets and shows that companies with higher ranking on the governance index have better operating performance and higher stock returns. Also, Klapper and Love's (2002) empirical study provides evidence that firm-level corporate governance quality matter more in countries with weak legal environments in attracting investors. This finding suggests that well-governed firms can compensate for weak legal/institutional environment and law enforcement at the national level by establishing good governance practices such as greater firm disclosure and stronger minority shareholder rights at the company level. However, the study also notes that firms on average have significantly lower governance rankings in countries with weak legal systems – suggesting that firm level efforts do not fully substitute for inadequate

Table I Importance of institutional factors when selecting emerging market countries and corporate level factors when selecting emerging market companies in which to invest (rated from 1 to 5, 5 being highly relevant, 1 being irrelevant)

<i>Most important corporate level factors</i>		<i>Most important institutional factors</i>	
Distinction between company and family interests	(4.5)	Enforceability of legal rights (e.g. contracts)	(4.5)
Clearly defined governance arrangements	(4.4)	Quality of economic management	(4.3)
Accuracy of financial reporting	(4.4)	Independence of judiciary/quality of legal system	(4.0)
Enforceable minority shareholder protection	(4.3)	Level of corruption	(3.9)
Use of performance-based compensation	(4.3)	Predictability and level of taxation system	(3.9)
Timeliness of financial reporting	(3.9)	Quality of accounting standards	(3.8)
Coverage of financial reporting	(3.9)	Effectiveness of regulatory system	(3.8)
Presence of non-executive directors	(3.8)	Administrative efficiency of government	(3.5)
Establishment of conflicts of interests committee	(3.3)	Effectiveness of banking sector	(3.3)
		Scale and liquidity of local investment market	(3.3)

Source: McKinsey Emerging Market Investor Opinion Survey, 2001

legal infrastructure. Klapper and Love's results support the findings in Schleifer and Wolfensohn (2002) that firms cannot create a good legal environment with firm level efforts.

One response to weaknesses in corporate governance environment by the firms is to participate in more developed markets, more specifically in the US. Empirical evidence shows that corporations from weak corporate governance environments are more likely to list abroad (Reese and Weisbach, 2000) and enjoy higher valuations compared to the firms from the same country listed only in local exchanges (Doidge *et al.*, 2001).

Finally, stakeholders other than shareholders and creditors possess a powerful ability to influence corporate behavior and performance. The concepts of corporate social responsibility and stakeholder involvement are important considerations in European Union's policy for an EU-wide level playing field in CG (ICGN, 2002). These concepts, as strong aspects of corporate governance traditions of Europe, have been more strongly spelled following the corporate crises in the USA. Most of the best practice codes and guidelines, including OECD principles, recognize the role of *stakeholders*. There are ongoing efforts to further incorporate stakeholder involvement principles into corporate governance structures with the view that such an involvement will be conducive to sustainable growth and development.

Turkey: the economic/political environment

Since mid-1990s, Turkey has distinguished itself with remarkably low shares of global foreign direct investment (FDI) flows and high levels (about 80 percent of GNP) of deposit accounts held locally and off shore by Turkish residents. These are significant indicators that suggest that Turkey is faced with a serious "investor confidence" problem. According to UNCTAD's 2001 World Investment Report (UNCTAD, 2001), Turkey has an inward FDI index of lower than 1, indicating that its ability to attract investors is below the level implied by its "economic fundamentals". Turkey's inward FDI performance index is even below the composite index for the emerging markets (Thomson Financial Datastream, 2 March, 2002, see *Financial Times*, 26 March, 2002).

Turkey's underperformance with respect to attracting FDI is neither a recent nor a transitory phenomenon. Compared to developing countries, Turkey has attracted much lower FDI flows in proportion to its gross fixed capital formation (GFCF) since mid-1980s. The ratio of FDI flows to Turkey's GFCF stagnated at less than 2 percent whereas the developing country average increased from less than 5 percent in mid-1980s to 14 percent in 1999. That Turkey's underperformance has been a long-term trend can be seen from the very low FDI stock relative to GDP. Turkey's FDI stock in 1985 (0.5 percent of GDP) was less than 4 percent of the developing country average (14 percent of GDP). Despite some increase in Turkey's FDI stock to 4.5 percent in 1999, the FDI stock in developing countries increased much faster to reach a level of 28 percent (see UNCTAD, 2001).

The underperformance in this area is closely related to investor or analyst *perceptions* of Turkey's CG framework as well as its wider political environment and macro-economic instability. Part of the explanation for this underperformance can be seen in a recent report by PricewaterhouseCoopers (2001), which ranks Turkey as the fourth least transparent country in the world. The estimated impact of opacity in terms of lost FDI is \$1.8 billion per year. Again, a research on 188 companies from South Korea, Malaysia, Taiwan, India, and Mexico places Turkey at the bottom of the ranking with respect to board oversight and transparency and second from the

bottom after Mexico with respect to shareholder rights (McKinsey, 2002). Perception issues of similar nature is reflected in Transparency International's Corruption Perception Index (TI, 2001, 2002). Turkey ranks 54th among 91 countries in 2001 (with a score of 3.6 out of 10) and 64th among 102 countries in 2002 (with a worse score of 3.2 out of 10) in transparency. Turkey is perceived to be more corrupt than Chile, Malaysia, Poland and Morocco and better than Argentina, India, Russia and Indonesia.

After the establishment of a Turkish republic, especially from early 1930s onwards, a strong emphasis has been placed on the role of the state in economic development. Until 1945, the state was the major economic player and subsidized the development of the private sector. A pro-market economic policy started to take shape after 1945, but the process continued to be marked with heavy state involvement in the economy. In fact, state involvement in the economy during the 1950s (both as producer and regulator) proved to be higher than the 1930s. Although state involvement in the economy continued throughout the 1960s and 1970s, the fledgling private sector eventually came of age and market economy institutions acquired a new dynamism. This dynamism has increased due to a new wave of pro-market policies in the 1980s – which started with the liberalization reforms of 24 January 1980 and continued with further liberalization under the military regime and the first civilian government led by Turgut Ozal thereafter.

Turkey is currently undergoing an IMF-sponsored restructuring process after having experienced high and persistent inflation but relatively high growth for more than two decades. Despite a positive outlook at the end of 2000, the Turkish economy was plunged into the deepest economic crises of its history in early 2001. The Turkish lira was devalued by 26 percent and the real GNP fell by 9.4 percent, reducing the GNP per capita to 2,160 US dollars, which is below per capita income in 1990 (see TUSIAD, 2001). The structural reform agenda that is either required by or run parallel to the IMF-sponsored program includes the following: reducing the role of state in the economy, reforming the problematic agricultural and energy sectors, amending the public procurement law, ensuring the independence of the Central Bank, restructuring of the banking system, adoption of international accounting standards, developing risk management techniques and transparency. Implementation of the program is perceived to be successful so far by the analysts and financiers, although there are no signs of growth yet. Structural public deficits and its financing pressure, although lessened, continue. Credit scarcity (in 2001, credit volume reduced by approximately 50 percent), stemming from the crowding out impact of the high public borrowing and the weak banking sector opting for attractive returns offered by the government, deprives the real sector from financial resources. Only in 2001, private sector investments fell by 35.1 percent. Hopes are tied to foreign investments to finance growth and productivity improvements (TUSIAD, 2002)

One of the problems is the quality of current portfolio flows. Speculative nature of the current portfolio flows and their volatility thereof increases the instability of Turkish market and introduces systematic risks. In fact, it was the sudden capital outflow in 2001 that triggered the last recession (in excess of 10 percent of the GDP). Similar phenomena triggered the Asian crises and caused an international debate on the risks involved with immature liberalization of capital markets in emerging markets (Aghion *et al.*, 1999).

Turkey's declared foreign policy aim since mid-1980s has been the achievement of full EU membership. This objective seems a natural outcome of the modernization project that dates back to the second half of the 19th century. It is also underpinned by economic considerations as more than 50 percent of Turkey's trade is with EU and Turkey is the EU's sixth largest trading partner. In addition, the EU also ranks first in terms of FDI flows to Turkey – accounting for about two-thirds of the total FDI flows between 1995 and 2001 (SPO Website, www.spo.org). In their Turkey update of 25 June 2002, Morgan Stanley estimates that EU membership may enable the Turkish economy to attract annual FDI flows of over US\$10 billion by 2015. This estimate is based on a conservative assumption of attracting net FDI flows of 2.2 percent of GDP. These investments can boost Turkish economy to achieve its potential growth rate of 7.5 percent (Morgan Stanley Web-site, www.morganstanley.com).

A major obstacle to the realization of these potentials is the role of the Turkish state in the economy and the way in which it interacts with civil society. The state's heavy involvement in the economy has led to two undesirable consequences. On the one hand, it fostered a political culture in which the legitimacy of the state is a function of the "rents" that the government could distribute rather than its ability to provide "public goods" such as stable macroeconomic environment, a transparent regulatory system, and social conflict resolution mechanisms, etc. On the other hand, the state's heavy involvement increased "private risks". Therefore, it induced private economic agents to pressure the government of the day to compensate at least part of their risks – irrespective of whether or not such risks have been due to government action or the private actors' own actions. This second tendency combined with the first and led to persistent favoritism, corruption practices, opacity, etc. – all of which have their own path dependencies (see Ugur, 1999, chapter 3). Now it is becoming increasingly evident that this system of political economy is not sustainable – as signaled by the financial crises of 1994 and 2000, and proved by the deeper crisis of February 2001.

Turkey: the CG framework

La Porta *et al.* (1997, 1998) redefined the analytical framework for comparative research on corporate governance by introducing an integrated approach to law and finance. La Porta *et al.*'s (1998) anti-director rights index aggregates six different shareholder rights and ranges from 0 to 6, where a higher score indicates better protection (proxy voting, cumulative voting, proportional representation of minorities on the board, oppressed minorities mechanisms, below 10 percent shareholding threshold to call for an extraordinary meeting, pre-emptive rights to shareholders which can be waived only by a shareholder's vote and non-existence of any need for shareholders to deposit their shares ahead of shareholders meeting). The legal efficiency index takes values from 0 to 10 and efficiency increases with the score. It produces a rating of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms". La Porta *et al.*'s accounting standards index is constructed by inclusion or exclusion of 90 items in annual reports. In a 40 country assessment, Turkey is rated two out of six with respect to shareholder's rights (worse than all including Philippines, Peru, Malaysia, Chile, Argentina, Colombia, India, and Pakistan but better than Mexico, Venezuela, Germany and Italy), four out of ten with respect to judicial efficiency (worse than all 40 countries except Thailand and Indonesia), 51 out of 90 with respect to accounting standards (worse than all but Argentina and Colombia).

Indeed, the corporate governance debate in Turkey revolves around three issues: (i) minority shareholders' and creditors' rights; (ii) enforcement of law and regulations;

and (iii) ambiguities and weaknesses in legal/regulatory framework. In what follows, we will examine the major elements of the Turkish CG framework and then discuss the manifestations of the deficiencies at the market and corporate levels.

The capital market and its institutions

Despite the long history of securities trading and achievements as an important market due to significantly high volumes in European scale in the past (see Tanor, 2000, Vol. 1, pp. 18-28), the modern capital market of Turkey has only 20 years of history. From 1980s onwards, there was a continuous increase in the number and size of joint stock companies that opened up their equity to the public. The Capital Markets Law (CML) was enacted in 1981 and the Capital Markets Board (CMB) was established. Secondary market operations, initially limited to equity trading, started in 1986 with the foundation of Istanbul Stock Exchange. In 1992, with amendments to the relevant legislation, the CMB's powers were increased to allow it to define new instruments in response to rapid market developments.

After a decade of successful performance until 2000, market activity declined with the economic crises and has not yet recovered. The decline started in 2000 with a loss of 31.8 percent of value in 2001. Market capitalization was 35 percent of GDP in 2000, but the current value is estimated to be around 20 percent. This is well below the OECD average of 137 percent. The total traded value was also down to US\$80.4 billion in 2001 from US\$181.9 billion in 2000. Based on the closing values of the last trading day of 2001, the total market capitalization was US\$47.69 billion compared to year-end 2000 figure of US\$69.5 billion. In 2001, public securities accounted for 92.1 percent of all securities (mainly stocks) and private securities accounted for only 7.9 percent in 2001 (mainly government bonds and treasury bills) down from 15.7 percent in 2000. The market is shallow with 278 (June 2002) trading companies with almost no initial public offerings after 2000 when a record of US\$2.8 billion of fund was raised through initial public offerings of 35 firms. Average free float is around 22 percent, mostly common shares. During the first quarter of 2002, 25 most actively traded companies represented 74 percent of ISE's trading volume. Activities were concentrated around financial institutions (Data: ISE Web-site, www.ise.gov.tr).

Turkey has a liberal foreign exchange regime with a fully convertible currency. There are no restrictions on foreign portfolio investors trading in the Turkish securities market or on repatriation of capital and profits. In their assessment of the Turkish equity markets, Aytac and Sak (2000) note this asymmetric development of primary and secondary markets and highlight the market's then high volume, high volatility and low yield characteristics. While the trading volume kept growing since 1986, the ratio of initial public offerings (IPOs) to new issues continuously declined (for reasons see Tanor, 2000, pp. 65-77). The size of primary market remains small indicating that the equity market is not a source of external funding. Aytac and Sak's analysis suggests that weak primary market is conducive to a combination of high trading volume and high price volatility. This, in return, is conducive to gains on speculative trading but hinders new participation. As of January 2000, there were approximately 84,000 joint stock companies incorporated in Turkey and only 0.3 percent of these companies' stocks were traded.

The Capital Markets Board (CMB), The Istanbul Stock Exchange (ISE), and Takasbank (Settlement and Custody Bank) are the major institutions involved in Turkey's capital market. The CMB regulates the operations of ISE. The CMB members are appointed by resolution of the Council of Ministers for six years. The CMB is equipped with ample regulatory power and is capable of directly imposing penalties – including suspension and cancellation of licenses. However, it cannot directly take the cases to court as this

right is granted to public prosecutors only. Latest amendments in 1999 led to the establishment of new institutions under the Capital Markets Law (CML), which include: The Association for Securities Dealers, The Securities Investor Protection Fund, The Accounting Standards Board and The Central Registrar for Securities further enhancing the institutional infrastructure for the market. Yet all regulations providing for these institutions have yet to be approved and enacted by the Cabinet. Nevertheless the 1999 amendments strengthened the powers of CMB.

The ISE's board and its chairman are appointed by the government from among the nominees submitted by the CMB for a five year term. It is governed by a general assembly attended by its trading members licensed by CMB. Takasbank, set up in 1996, is Turkey's central securities custody and national numbering agency compliant with ISSA G30 guidelines and US SEC rules 17f-5. Takasbank is solely authorized for safekeeping of securities. As of June 2001, the ISE owns 22.6 percent of Takasbank, the rest is owned by 27 banks and 77 brokerage houses. Takasbank is regulated by CMB with respect to its securities depository functions and by newly formed Banking Regulation and Supervisory Agency (BRSA) and Central Bank with respect to its banking services.

The recent history shows that both the CMB and ISE have been responsive to market needs and that their structural fundamentals do not impose any problems for performing their roles. Nevertheless, there are two reasons for concern. One is the relative lack of flexibility and innovation caused by the "public servant" status of their employees. The other is the inefficiency of the organizational framework caused by the slowness and inadequacy of the judicial system.

Corporate ownership and control structure

According to Aytac and Sak (2000), in 45 percent of 243 listed companies in Turkey one shareholder controlled more than 50 percent of the voting rights. In majority of the cases, the dominant shareholder was a holding company controlled by a family. The survey also indicated that a vast majority of the firms (except about 20) did not use the capital market for funding purposes. Yurtoglu (2000), in a study of Turkish listed firms, concludes that Turkey has an "insider system" of corporate governance in the terminology of Frank and Meyers (1997). This CG framework is characterized by: (1) few listed companies, (2) a large number of substantial share stakes and (3) large inter-corporate shareholdings. Yurtoglu's findings show that 99 of the 257 listed companies have one shareholder with an ownership stake of at least 50 percent. 227 companies have five or fewer shareholders with at least 50 percent of equity under their control.

According to Yurtoglu, holding companies are the largest owners with ownership stakes in 143 companies and with an average stake of 36 percent. Yurtoglu's study also reveals that the ultimate owners of listed companies are mostly individual family members exercising control on cash flow rights through pyramidal and cascaded ownership structures. Families control 198 of the 257 companies with average 53.8 percent holding of the equity capital, a figure substantially higher than average direct shareholding of families (27.1 percent). The ratio of the voting rights of the ultimate shareholdings of the same owner is cited as 1.32 indicating that the ownership and cash flow rights are not dramatically diffused. Yurtoglu suspects that this may be due to 50-50 joint ventures with multinational firms. The ownership structures are relatively transparent. Under CMB's disclosure requirements, the CMB and ISE must be notified immediately of any purchase or sale of shares amounting to 1 percent of the share capital by any acquirer or group of acquirers acting in concert with those who

already hold 10 percent or more of the shares or voting rights. Disclosure of ownership structure and identity of major shareholders owning more than 10 percent of the shares or voting rights is also mandatory.

The debate on the impact of ownership structures on the quality of corporate governance and whether one ownership structure is preferable to others is a lively one. As early as in 1950s, Berle (1958) suggested that some ownership concentration is required to ameliorate agency problems. That is because, in the presence of dispersed ownership, investors have little incentive to engage actively in monitoring and control of companies but prefer to "free ride" on the monitoring performed by others. In the case of concentrated ownership, however, the owners have the incentive and means to monitor management closely. Furthermore, they support decisions to enhance companies' long term value creation capabilities. Supporting Berle's thesis, Gomes and Novaes (1999) argued that maximally efficient corporate structure consists of multiple large shareholders together with some minority shareholders.

This wisdom, however, was questioned by the apparent performance of the US and the UK market against that of continental Europe. Fox and Heller (2000) suggest that their findings contradict the recent theoretical and empirical research which suggests that control by multiple large shareholders may improve firm performance. Carlsson (2001), based on his research on Scandinavian enterprises, concludes that "ownership matters, and it all depends on the owner" – pulling the debate to shareholder responsibility. The findings by Oman (2001) go a long way in explaining why issuing corporate equity may not be a major source of funding in countries where concentrated ownership is the norm. Yet, the perennial problem remains unresolved: ownership concentration goes together with weak investor protection. Himmelberg *et al.* (2002) add a new dimension to the problem. They predict that agency problems force insiders to retain a larger share than they would under a perfect risk diversification strategy. Using data from 6,165 firms from 38 countries including Turkey, they provide evidence that the weaker the investor protection, the higher is the concentration of inside ownership. They also demonstrate that this higher concentration of ownership results in higher implied cost of capital and underinvestment. One important conclusion of their study is that lowering international barriers to capital flows is not sufficient since capital will not flow unless adequate investor protections are in place.

Research on corporate structures in Turkey provides significant evidence suggesting that the *holding company* structure affects the economic performance of Turkish firms – including profitability, return on assets, dividend payments and investment decisions. For example, Yurtoglu (2000a) finds out that concentrated ownership and pyramidal structures have been conducive to lower return on assets, lower market to book ratios and lower dividends. Yurtoglu (2000b) demonstrates that profit rates of Turkish companies tend to diverge from the competitive market rates for longer time periods when these companies are part of the holding company structure and their leverage levels are low.

There is no research on Board compositions in Turkey. There is no requirement for non-executive or independent board members or for any board committees. Observations and anecdotal evidence suggest that both the statutory boards and the executive boards are dominated by family members and they largely overlap. Non-executive directors are very rare and are observed in case of significant foreign participation. In cases where CEO is not a family member, he is usually a long-term acquaintance of the family. Family councils or family constitutions are also very rare. Family members are given responsibility to oversee a certain business sector as the

group CEO in the holding structure and usually perform the role of the Chairman of the Board for the individual companies. In general existing structures are not conduit to effective performance monitoring. The CMB does not have the power to disqualify or sanction directors.

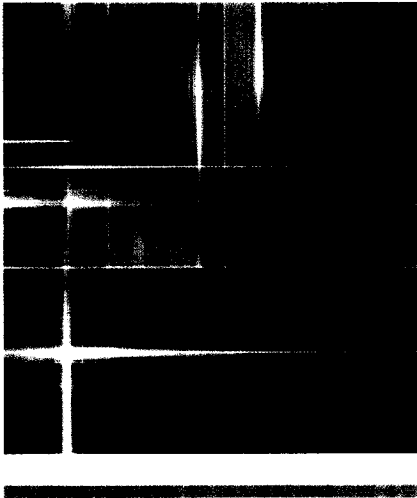
Another feature of Turkish corporate structure is the financing system structured around big business groups (a *holding company*) with a group-owned bank. Research on the performance implications of bank-centered finance and close bank-firm relations focuses on East Asia and Japan and its findings are inconclusive. There are arguments that a well-balanced financial system with financial intermediation by both banks and capital markets can absorb shocks better. Claessens, Djankov and Pohl (2002) report positive influence of indirect bank ownership (through investment funds) on profitability and market valuation of corporations. The current global debate is focused on the governance of the banks and related lending rather than the source of finance.

The legal framework and law enforcement

The relation between market efficiency and a country's legal system has long been a subject of detailed research. La Porta *et al.* (1997) concluded that statutes in common law countries are superior to civil law in protecting creditors and, hence, in protecting investors in general. On the other hand, the analysis of the relations between law and culture has led Licht *et al.* (2001) to suggest that La Porta *et al.*'s legal approach provides only a partial depiction of the universe of corporate governance regimes. Their findings support the argument that there is culturally-induced path dependence in corporate governance regimes – also suggesting that cultural values partly determine the types of legal regimes likely to be accepted as legitimate in a country.

La Porta *et al.*'s research shows that French civil law countries are least protective of minority shareholders. Turkey is a country in the French tradition. One of the building blocks of CG legislative framework, the Commercial Code (CC), was originally taken from French Commercial Code in 1850 and amended in 1926 and 1956 – with provisions taken from German, Swiss and Italian law. The 1956 version, with its evidently eclectic nature, forms the basis of equity contract and provides the legal framework for incorporation, general assemblies, shareholder rights, definition of shares and bonds and their issuance. The CML had provisions taken from the Anglo-Saxon (common law) legal system but still has its roots in civil law. It primarily provides the legislative framework for securities market activities and establishes the CMB. Separate laws regulate the banking and insurance sectors. A major issue of legislation is related with the ambiguities in law and inconsistencies between Commercial Code, Capital Markets Law and Banking Law with respect to disclosure, accounting, taxation and shareholder rights.

There are severe operational problems with the legal process and law enforcement in Turkey. The legal system is complicated, slow and costly. With the 1999 amendment, the CMB is empowered to avoid such impediments by resorting to administrative fines – including suspension and de-listing. However, these new powers are compromised by the general inefficiency of the legal process and the weaknesses in law enforcement. Since 2000, the CMB has filed complains to the office of public prosecutors for around 100 violations of CML per year. Only one case in each year has reached decree absolute, with the rest resulting in dismissals and adjournments. The average time between the CMB's appeal and the first verdict (excluding decisions on adjournment and dismissal) is 12 months. The public prosecutor has not reacted yet to files concerning 26 cases in 2001 and half of the cases in 2002. The result is that only 1 percent of all complains end up with any punishment. Most of the offences



(218 out of 272) are related with Article 47 of CML which provides the legal framework to cope with market manipulations disturbing the fair trading environment and introduces penal liabilities. (CMB Web-site: www.spk.gov.tr)

An important remark made by Tanor (2002) relates to the imbalance between authorities and duties of the CMB. Tanor refers to the recent take-overs of under-capitalized banks as an example of how this imbalance manifests itself in practice as a conflict between rule and its application: CML recognizes the special law that the banks are subject to and makes references to them. However the banks listed in ISE are also subject to CML as "issuers" with respect to audit and disclosure provisions. It had become evident by the take-over of some public banks by BRSA that these banks did not comply with the disclosure provisions. Tanor reports that CMB could have used its authority since disclosure offences are of criminal nature. However, the CMB has refrained from taking such action and, therefore, demonstrated that it can eschew its responsibilities when difficult decisions are involved. Tanor points out the vital importance of regulatory authority to exercise its powers firmly and thoroughly in auditing and monitoring compliance.

Disclosure infrastructure

Governance is ultimately concerned with the alignment of information, incentives and capacity to act' (Monks and Minow, 1995). It involves the monitoring of the corporation's performance and the monitor's ability to observe and respond to that performance. Insufficient and/or unclear information may hamper the ability of the markets to function, increase volatility and the cost of capital, and result in poor allocation of resources (La Porta *et al.*, 2000). It is apparent that market forces for transparency would be weaker where ownership is concentrated and related lending by banks form major source of finance. This partially explains the lack of strong disclosure tradition in Turkey. Deficiencies in standards of transparency and accountability allow corporate management (therefore major shareholders) to avoid disclosure and manipulate markets by misinformation. These weaknesses are conduit to asset transfers and asset stripping. According to Gilson (2000), effective disclosure requires legally mandated disclosure requirements, good accounting standards, independent auditors, and enforcement. These standards are highly significant in ensuring that stakeholders have sufficient, timely, credible, comprehensible and cost-effective information to monitor the company's performance.

The Turkish accounting system is not compatible with the International Accounting Standards (IAS). This discrepancy restricts investors' ability to make informed decisions about investment alternatives. A research jointly undertaken by 7 major global accounting and auditing firms compares written national accounting standards of 62 countries and benchmarks them against IAS (see GAAP, 2001). It is apparent that Turkey is one of the 4 countries (Lithuania, Slovenia, Morocco and Turkey) where national standards have at least one major difference from IAS and it is the only country with deviation in more than one area. It is reported that in two key areas, the absence of Turkish rules leads to important differences from IAS: inflation adjusted reporting and mandatory financial consolidation for parent enterprises. This benchmark is based on the accounting standards issued by the CMB. There is no set of generally accepted accounting principles that applies equally to all companies operating in Turkey other than general rules that govern the aspects of accounting in the Tax Procedures Code and the Uniform Chart of Accounts which prescribe a code of accounts and a format for presentation of financial statements. Aware of the negative implications of these anomalies, many Turkish companies (in the order of hundreds according to the local office of one of the reporting firms) have already

begun producing IAS-compatible financial statements. Obviously this voluntary act does not protect them from paying taxes based on fictive profits created by hyperinflationary economic conditions. Indeed, CMB has issued draft standards on inflation accounting and consolidation in line with IAS requirements; however the changes required in the tax code are pending to be discussed in the parliament after several postponements.

Compliance with requirements is assured by internal audits, external audits and regulatory audits. The internal audit framework is defined in the CC, but the provisions are vague. External audits are required only for listed companies. External auditors have to be certified by CMB. The Independent Audit Association founded in 1988 does not have statutory position to self-regulate the profession. It is arguable that the audits are credible and objective. In case of failures, the ISE and the CMB can issue private and public warnings, impose penalties, suspend trading or may put the companies on a "watch list" (companies on watch list can trade for only 30 minutes per day). Regulatory audits are conducted by the CMB or by external auditors appointed by the CMB in case of complaints, suspects or when there is a need such as in the case of mergers and acquisitions. Although the existing regulations and the planned improvements present significant improvements, compliance is still a problem to be addressed.

Shareholders' rights/investor protection

In Turkey, the fundamental document governing the shareholders' rights is the company's articles of association – which should provide for the rights to participate in the general assembly, to vote and acquire information, to have the company audited, to file a complain, and to take civil or legal action. There are no mandatory provisions in the CC. In addition, the CC provides for privileged shares and imposes practically no limit to the extent of privileges that may be granted – including multiple voting rights, pre-determined dividend rate, priority entitlement at the time of liquidation etc. Minority rights start from 5 percent for public companies and 10 percent for non-public ones according to the Commercial Code. Shareholders can vote by notarized proxy by appointing a representative through a power of attorney; however the procedure is complicated and costly.

Insider trading or the trading of by the use of non-public information is a crime with penal liability and 2-5 years of imprisonment and heavy fine. Dissemination of false or misleading information is also covered under the same provision. The 1999 amendments to CML brought 2-5 years imprisonment to transfer of assets and profits out of firms (tunneling) for the benefit of those who control them. The CMB can take any violation of shareholders rights with respect to insider trading and manipulative practices to the public prosecutors; however the provisions are not clear and subject to interpretation. Despite the lack of final sentences, the high number of suspected cases and anecdotal evidence suggest that insider trading and tunneling are still common. In fact, although certain forms of tunneling in the form of theft or fraud are illegal in many countries, in cases where the judgement has to be based on whether the directors exercised their "duties of loyalty and care", proof may be very difficult in countries where civil law tradition prevails.

Conclusions: some policy implications

Higher standards of corporate governance have been proposed as a means of increasing the accountability of the users of funds to supplier of funds and therefore of inspiring investor confidence in market economies. With weak corporate governance, management may effectively "steal" from shareholders and majority shareholders from both minority shareholders and the public. Furthermore, without strong corporate

governance practices, corporate misconduct and mal-performance may continue without detection. Effective corporate governance system is also essential for development of equity markets which are associated with higher rates of economic growth (Demirguc-Kunt and Maksimovic, 2000).

Corporate governance literature has been growing and multi-disciplinary, cross-border research initiatives have been proliferating. The search is no longer focusing on finding ways to help capital formation in emerging and developing markets but on understanding the role of corporate governance in corporate performance as well as finding the right balance between regulatory and market-based incentives/penalties. Turkey is no exception with a growing interest in corporate governance from academics, business circles, policymakers and regulators and with recent government initiatives to improve corporate accountability and control in the financial sector.

Despite the differences in starting points and paths followed, a trend towards convergence of corporate governance regimes has been developing (Nestor and Thompson, 1999). However, convergence does not imply that reform plans should be identical. Lessons derived from recent, post-crises reform experiences show that no single model of corporate governance will adequately solve the governance issues in every situation and each country should formulate its own reform plan that suits its specific conditions (ADB, 2000).

Turkey's investment climate is not radiating confidence to the investors. Turkey is perceived as an opaque and corrupt country. Capital market is characterized by low liquidity, high volatility, high cost of capital (low firm valuation) and limited new capital formation. Controlling shareholders maintain large stakes and have leveraged cash flow rights due to privileged shares and pyramidal ownership structures. Risk of expropriation by insiders is high. Shortcomings in the legal and regulatory framework contribute substantially to the risks of investing in equity markets in Turkey. While Turkey's ongoing restructuring efforts include major programs to remove barriers for foreign direct investments and improve governance of the financial sector, equally important would be to create a well developed equity market to inject high level of domestic savings into investments and attract foreign institutional investors. This will require an effective corporate governance system which relies on a combination of firm level and institutional control. An effective property rights regime, enforcement of contract law, a well-regulated banking sector, adequate and enforced bankruptcy procedures, sound securities markets, laws and regulations that ensures competition and remove barriers to foreign investment, transparent and fair privatization procedures, transparent and fair taxation regimes, an independent, well-functioning judicial system, effective anti-corruption measures, empowered and participative public, an investigative and informed media, strong reputational agents (self regulatory bodies such as accounting and auditing professionals, corporate governance analysts, consumer activist and environmentalist), an active, integrity-based business community are essential institutional components of good corporate governance (CIPE, 2002). The challenge is to pace, sequence and synchronize the following reform components:

Internal controls: corporations

Corporations should pursue improvements by including provisions of transparency and minority protection rights in company charters. McKinsey's 2002 Investor Opinion Survey indicates that investors are willing to pay a premium of 27 percent for a well governed company in Turkey (McKinsey, 2002b). OECD guidelines and EASD principles (EASD, 2000) and many best practice codes provide a comprehensive framework for defining voluntary best practice codes of corporate governance. These

provisions may include IAS based reporting, quarterly reporting with disclosure of non-financial information, adapting one share-one vote principle and stopping issuance of non-voting common shares, allowing cumulative voting, setting up board committees for audit, nomination and compensation with independent board members, adoption of best practice codes, disclosure of corporate governance system etc.

Furthermore, corporations – through their business organizations such as the Chamber of Commerce (TOB), and TUSIAD – should promote awareness, encourage professional development and training, support and involve in research and finally co-ordinate with regulatory bodies (CMB, ISE, and BRSA) and research institutions to identify the priorities, scope and pace of regulatory reforms.

Legal and institutional framework

Accounting standards needs the highest attention. A national accounting standards agency should be formed and standards should be improved to minimize the discrepancy from the IAS. A joint initiative between the government and the CMB should focus on eliminating the ambiguities in and inconsistencies between Commercial Code, Banking Law and Capital Markets Law especially with respect to disclosure, taxation and property rights in consultation with business organizations. Commercial Code should be reviewed and amended to have clear provisions for shareholder rights and directors liabilities.

Adoption of best practice codes through regulation (voluntary adaptation but mandatory disclosure of reasons for non-compliance) should be considered. Independence, continued professionalization and transparency of regulation and supervision should remain high in the agenda. Another important consideration for deciding on the scope of reforms is to understand that potential benefits of improved governance on growth can only be achieved if a competitive environment is supported by policies and sector specific regulatory reforms where monopolistic/oligopolistic structures exist.

Enforcement

Given the complexity and difficulty of reforming the legal framework (and most importantly, creating a strong legal environment with enforcement capabilities), increasing the direct powers of the market regulators and setting up arbitration institutions and administrative courts should be considered (World Bank Group, 2002). However, reforming the judicial system especially with respect to enforcement should remain as a priority in the agenda of policy makers. Needless to say, this will require time and financial resources and is not specific to corporate law.

Business ethics and behavior

Changes in rules and legislation and even their effective enforcement do not necessarily lead to changes in values, behavior and attitude. Creating a culture where ethical behavior and integrity is valued in business as well as in day to day life is a matter for civil society, business and professional organizations to focus on. The legislation around civil society organizations in Turkey also needs serious reforms as the current framework is limiting. Business schools can play an important role by incorporating business ethics and corporate governance courses in their programs, civil society organizations can encourage responsible business conduct through recognition of good practices.

Existence of an independent and alert media sensitive to and capable of detecting corporate mis-conduct and politically-endorsed tunneling is essential. Given the highly monopolized status of the media in Turkey, this issue needs special attention.

Last but not the least, in pursuing a membership status in European Union, Turkey should align its reform initiatives to the developments in Europe to harmonize company law.

Further research

We are of the view that further research is required to reduce two types of risks; (i) risk of apathy or slow reaction; (ii) risk of adopting new rules, institutions, or procedures that do not add up or fit into a coherent CG framework that will be "owned" by the business community as well as stakeholders.

Future research should include identifying pathologies of corporate governance failures in Turkey and their root causes, understanding the forces for and against reforms, and analysis of culture and societal values as they influence corporate governance practices.

Turkey offers a rich base for empirical research for behavior of family-owned firms. We suggest that this could be exploited for comparative and cross-border research for finding solutions to corporate governance problems related to insider ownership and control.

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