

**Recognition of Corporate Governance Principles in Turkish
Legislation and their Impact on the Influx of Foreign Equity Capital
into Turkey**

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ABSTRACT

Due to the low domestic savings rate, Turkey is in strong need of foreign capital to finance investment and cover account deficits. However, foreign investors traditionally shy away from companies in which insider control is high.

As in the case of many emerging markets, Turkey's corporate landscape is characterized by a high percentage of family owned companies. Turkey has been classified as an 'insider system' in terms of corporate governance, which means that it is shaped by relationships between controlling families and managers. The obscure nature of insider control is a source of concern for foreign investors, as the lack of information and transparency increase the cost of investment. Risk, which affects the potential profit, is one of the main aspects of any decision regarding investment. Therefore, in order to for the Turkish market to gain benefit from the inflow foreign capital, the focus of policy makers should be not only on profitability, but also on transparency and accountability to reduce investment risk.

Corporate governance has relatively recently arisen as one of the main factors underlying investment decisions, as it reduces the risk caused by the lack of trust and confidence in the investment environment. However, the level of compliance of Turkish companies with the existing corporate governance standards of Capital Markets Board of Turkey has been quite low. Thus, the new Turkish Commercial Code proposed important reforms towards a corporate governance framework for Turkey. The purpose of this Thesis is to evaluate whether the implementation of the Turkish Commercial Code reforms with regard to corporate governance has had an impact in Turkey's attempts to attract more foreign equity investors into Turkish Capital Market.

The relationship between corporate governance and foreign investment has been studied in other market economies, but studies focusing on Turkish market are rare, and virtually none of them take into account the legal aspects of the problem. Even though there is literature showing an improvement on the corporate governance standards after the new Commercial Code, the effect of corporate governance legislation on foreign investment in Turkey is an issue worthy of further examination. This Thesis contributes to the existing literature by evaluating the effect of corporate governance legislation on attracting foreign investors in the case of Turkey. The findings illustrate that, even though there is still room for improvement, the new regulatory framework has had a positive impact on foreign investors and their perception of the Turkish market.

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INTRODUCTION

Turkey is a rapidly growing emerging market, which has enjoyed increases in the annual economic growth rate during the period 2003-2014.¹ The average growth rate is approximately 5%. However, the percentage of foreign equity investors has not increased more than 1% of the total number of investors in Borsa Istanbul (BIST²) during the same period.³ Academic research to date provides little explanation for the low levels of foreign equity investors investing in Borsa Istanbul, the only stock exchange in Turkey.⁴ Given the low level of foreign equity investors in Borsa Istanbul, a market which demonstrates unique features in its corporate ownership structure, the relationship between foreign investors and corporate governance is worth exploring.

1. Corporate Governance and Foreign Investors

When investors provide capital to a company, they face the risk that their interests may diverge from those who influence the company's decisions.⁵ Although this problem exists in both concentrated and dispersed ownership structures, the source of the problem differs. Research shows that concentrated ownership, ownership by large

¹ International Monetary Fund, 'World Economic Outlook' 2012. See also OECD, <http://stats.oecd.org/index.aspx?DataSetCode=EO92> INTERNET accessed on 01 July 2015.

² On 5 April 2013 the name of Istanbul Stock Exchange was changed to Borsa İstanbul (BIST).

³ See Central Registry Agency of Turkey, Exchange Trends Reports https://www.mkk.com.tr/project/MKK_EN/file/content/Information%20Center%2FExchange%20Trends%20Report%2FBIST_Trends_Report_III for December 2012, https://www.mkk.com.tr/project/MKK_EN/file/content/Information%20Center%2FExchange%20Trends%20Report%2FBIST_Trends_Report_VII for December 2013 and https://www.mkk.com.tr/project/MKK_EN/file/content/Information%20Center%2FExchange%20Trends%20Report%2FBIST%20Trends%20Report%20XI for December 2014 accessed on 26 June 2015

⁴ See Chapter 3 Section 1.3 pg. 107 for BIST.

⁵ Michael C. Jensen and William H. Meckling 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) Journal of Financial Economics 305, 308. See also Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) Vol.105 No.430 The Economic Journal 678, 681 and Shann Turnbull, 'Corporate Governance: Its Scope, Concerns and Theories' (1997) 5(4) Corporate Governance: An International Review 180, 189.

investors, is the predominant ownership structure of public companies around the world.⁶ In the concentrated ownership structure, the controlling shareholder holds an effective majority of the firm's voting and equity rights.⁷

It is claimed that concentrated ownership helps to solve conflicts between managers and shareholders because controlling shareholders have the power as well as the incentive to monitor and, if necessary, to discipline the management.⁸ However, concentrated ownership can have its own corporate governance related problems. An important difference between concentrated ownership and widely-held ownership structures is the problem of agency. In the former, this problem involves managers acting for the controlling shareholders while in the latter it involves managers not necessarily acting for all shareholders.⁹ In concentrated ownership structure, the concern is that managers may not act for all investors but only for the concentrated owner. Considering the behaviour of these controlling shareholders, it is suggested that they have the tendency to ignore minority investors' interests.¹⁰ In addition, company group structures that bring together diversified businesses under the common control of a controlling shareholder add further complexity to concentrated

⁶ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, 'Corporate Ownership Around the World' (1999) 54(2) *Journal of Finance* 471 and Andrei Shleifer and Robert W. Vishny, 'A Survey on Corporate Governance' (1997) 52(2) *Journal of Finance* 737.

⁷ Zohar Goshen and Assaf Hamdani, 'Concentrated Ownership Revisited: The Idiosyncratic Value of Corporate Control' (2013) European Corporate Governance Institute - Law Research Paper Series Paper No.206 3.

⁸ Jensen and Meckling, (n. 5) 312-313.

⁹ For more detail on agency problems see Chapter 2 Section 1.2 pg 68. Randall Morck and Bernard Yeung, 'Agency Problems in Large Family Business Groups' (2003) 27(4) *Entrepreneurship: Theory and Practice* 367, See also Lutgart A. A. van Den Berghe and Steven Carchon, 'Agency Relations within the Family Business Systems: An Exploratory Approach' (2003) 11(3) *Corporate Governance* 171, 173.

¹⁰ Stijn Claessens, Simeon Djankov and Larry H.P. Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 *Journal of Financial Economics* 81, 109. See also Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Tunnelling' (2000) 90(2) *The American Economic Review* 22.

ownership.¹¹ Due to their complicated ownership structures, they are reputed to be less transparent.¹² Lack of transparency in these companies can be a further obstacle to effective monitoring by non-controlling shareholders. Indeed, concentrated ownership does not appear to be the solution to the agency problems that investors may face.

There are also a few studies that have looked into the importance that foreign investors place on corporate governance arrangements when making investment decisions.¹³ Studies highlight that corporate governance systems in emerging states may have an impact on the amount of foreign investment flowing in these countries. It is suggested that there is a close relationship between corporate governance and the portfolio composition held by foreign investors.¹⁴ The evidence also suggests that there is a negative relation between foreign ownership and ownership concentration.¹⁵ Foreign equity investors are less likely to invest in companies with concentrated ownership and group structures of family companies. However, when they do so, they prefer to invest in companies where problems of transparency are less pronounced.¹⁶

¹¹ George Dallas and Melsa Ararat, 'Corporate Governance in Emerging Markets' Harvard Law School Forum on Corporate Governance and Financial Regulation (2011)
< <http://corpgov.law.harvard.edu/2011/08/24/corporate-governance-in-emerging-markets/>> accessed on 26 June 2015

¹² Tarun Khanna and Krishna Palepu, 'Emerging Market Business Groups, Foreign Intermediaries, and Corporate Governance' in Randall K. Morck (ed.), *Concentrated Corporate Ownership* (University of Chicago Press, 2000) 288. See also Paul Davies, Klaus J.Hopt and Richard G.J. Nowak, 'Boards in Law and Practice: A Cross-Country Analysis in Europe' in Paul Davies, Klaus J.Hopt, Richard G.J. Nowak and Gerard Van Solinge (eds) *Corporate Boards in Law and Practice A Comparative Analysis in Europe* (Oxford University Press, 2013), 55-56, who state that self-dealing and conflict of interest resulting from appropriation of company opportunities are frequent in group of companies.

¹³ See Joon Kim, Jiyeon Eppler-Kim, Wi Saeng Kim and Suk Joon Byun, 'Foreign Investors and Corporate Governance in Korea' (2010) 18 Pacific-Basin Finance Journal 390. See also Praveen Das, 'The Role of Corporate Governance in Foreign Investment' (2014) 24(3) Applied Financial Economics 187-201. More on Section 6 of Chapter 1 pg. 46 on the role of corporate governance in foreign equity investment.

¹⁴ Magnus Dahlquist, Lee Pinkowitz, Rene M. Stulz and Rohan Williamson, 'Corporate Governance and the Home Bias' (2003) 38(1) The Journal of Financial and Quantitative Analysis 87, 109. See also Kim et.al Ibid, 390-402.

¹⁵ Magnus Dahlquist and Göran Robertsson, 'Direct Foreign Ownership, Institutional Investors, and Firm Characteristics' (2001) 59(2) Journal of Financial Economics 413, 429.

¹⁶ Khanna and Palepu (n. 12)

Studies examining the factors that drive foreign equity investment have indicated that foreign investors invest less in companies located in states with limited investor protection and poor disclosure, stating that monitoring costs and problems of gathering information are important factors behind their decisions.¹⁷ As it has been shown most studies to date clearly indicate that corporate governance is a factor for foreign investors and a determinant of foreign equity investment decisions. However, none of these studies has focused on the Turkish market.

2. Turkey as a Subject of Research

The Turkish government has expressed its intention to make Turkey one of the world's 10 largest economies by 2023, the 100th anniversary of the founding of the Turkish Republic.¹⁸ In June 2011, the current government won the elections for the third time. This long period of political stability has aided economic growth. GDP growth averaged nearly 7% during the period 2003-2007, while after the 2008 global crisis growth resumed rapidly at approximately 5% for the period 2010-2014.¹⁹ However, Turkey faces the challenge of financing its high growth performance with low domestic savings.²⁰ The state's large account deficit remains a critical point of concern. Turkey's economic growth relies on foreign capital influx as a means of financing its investments and growth. Foreign equity investment is a key factor for meeting the state's saving deficits. Although Turkey has a liberal foreign exchange regime and there are no restrictions on foreign equity investors trading in Borsa Istanbul, the number of foreign equity investors remains low in relation to all investors.

¹⁷ Christian Leuz, Karl V. Lins and Francis E. Warnock, 'Do Foreigners Invest Less in Poorly Governed Firms?' (2009) 22(8) *The Review of Financial Studies* 3245, 3280

¹⁸ See Justice and Development Party (AKP) <https://www.akparti.org.tr/site/hedef/2292/dunyanin-ilk-10-ekonomisi-arasina-girecegiz> accessed on 08 June 2015.

¹⁹ IMF (n. 1).

²⁰ For more information see Chapter 1 Section 5 pg. 41

In Turkey, state intervention in economic affairs was generally widespread until the late 1980s. The State assumed the role of providing capital to the private sector, while small number of family-owned businesses possessed the considerable competitive advantage of privileged ties to the state. State-business relations are a major determinant of the structure of current big business in Turkey.²¹ These relationships resulted in Turkish firms possessing highly concentrated and centralized family based ownership structures, with boards dominated by owners. Families, directly or indirectly, hold the control of companies.²² The separation of ownership and control is mainly achieved through a complicated web of inter-corporate shareholdings and pyramidal structures. Such structures allow the owners to raise capital in the equity market without losing control of their company. The distinctive feature of the Turkish business environment is the presence of company groups, while most of them have their own banks. Due to this, the monitoring role of the banks is undertaken in a way that reinforces the interests of the owner family.²³ Also, the majority of Turkish companies have little incentive to access external capital, due to their ability to transfer internal capital from their subsidiaries.²⁴ Hence, the Turkish corporate ownership and management control system can be classified as insider-controlled. This creates fertile ground for the abuse of minority shareholders by controlling

²¹ See Chapter 2 Section 3.1 pg. 75 and Section 3.2 pg. 78

²² Istemi Demirag and Mehmet Serter, 'Ownership Patterns and Control in Turkish Listed Companies' (2003) 11(1) Corporate Governance 40, 47.

²³ Burçin Yurtoğlu, 'Ownership, Control and Performance of Turkish Listed Firms' (2000) 27(2) *Empirica*, 193-222

²⁴ Mine Aksu and Hassan Espahbodi, 'The Impact of IFRS Adoption and Corporate Governance Principles on Transparency and Disclosure: The Case of Borsa Istanbul' (2015) *Emerging Markets Finance and Trade*, 1, 5

shareholders since controlling shareholders play a crucial role in the strategic decisions of the companies.²⁵

Furthermore, due to its ownership structure, Turkey has been slow in improving its transparency and disclosure enforcement mechanisms. As acknowledged in the Report of the Institute of International Finance, the protection of minority shareholder interests rests primarily on full disclosure and accurate financial reporting in Turkish companies.²⁶ The lack of transparency culture combined with inconsistent and opaque disclosure policies has resulted in problems, such as tunnelling, insider trading and market manipulation.²⁷

Due to the concentrated ownership of Turkish companies, active corporate control does not exist.²⁸ Thus, because of the weak enforcement of rules, accompanied by the influence of the withholding of information by controlling shareholders, the rules relating to accountability and transparency have not, until recently, been regulated under Turkish law. Shortcomings in the regulatory framework further contribute to the risks of investing in Borsa Istanbul. This investment environment suggests that, when it comes to Turkish corporate governance, the focus of reforms should primarily be placed on the implementation of transparency and accountability principles. Investors need information to evaluate corporate performance for their decision-making process. Lack of information increases risks and the uncertainties and decreases the attractiveness of firms. Besides, due to lack of information, investors have to make more effort to access unpublished information, which may lead to greater costs. Thus,

²⁵ Cüneyt Yüksel, 'Recent Developments of Corporate Governance in the Global Economy and the New Turkish Commercial Draft Law Reforms' (2008) 3(2) *Journal of International Law and Technology* 101, 101.

²⁶ The Institute of International Finance, *Corporate Governance in Turkey – An Investor Perspective Task Force Report* 2005, 3.

²⁷ Mine Aksu and Arman Köseadağ, 'Transparency and Disclosure Scores and their Determinants in the Istanbul Stock Exchange' (2006) 14(4) *Corporate Governance: An International Review* 277, 281.

²⁸ Yurtoğlu, (n. 23), 195.

poor corporate governance discourages investors to provide capital required by companies. A weak flow of information to shareholders can be expected to decrease the effective use of corporate governance mechanisms in corporations.²⁹ Transparency and disclosure practices form important components of the quality of corporate governance.³⁰ Therefore, shareholders prefer to pay higher premiums to companies that have a better and more effective disclosure system.³¹ Investors tend to prefer well-informed financial markets. This indicates that, in order to lower the risks and attract investors, a high level of transparency and accountability seems to be essential in corporations. Better transparency and accountability not only provides an effective flow of information, but also improves monitoring systems. Hence, to some extent, the risk of investment can be reduced because increased transparency provides useful information to shareholders with regard to buying, selling and holding equities in the market and adequate disclosure increases the decision-making powers of shareholders. As discussed by Alp and Ustundag, Turkish companies need to improve their transparency and accountability policies in order to access foreign capital and finance growth.³² Hence, firms wishing to attract foreign capital to finance their growth should be willing to prioritise an increase in their transparency and accountability, thus signalling their commitment to disclosure. This being the case, this Thesis suggests the importance of enhancing the transparency and disclosure, while reducing

²⁹ Eilis Ferran, 'The Role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-Informed Decisions', (2003) 4(4) European Business Organization Law Review, 491

³⁰ See Chapter 1 Section 6 pg. 46

³¹ Capital Markets Board of Turkey Corporate Governance Principles <http://www.spk.gov.tr/displayfile.aspx?action=displayfile&pageid=55&fn=55.pdf> accessed on 11 December 2015 See also Vikramaditya Khanna and Roman Zyla, 'Survey Says... Corporate Governance Matters to Investors in Emerging Market Companies' International Finance Corporation < http://www.ifc.org/wps/wcm/connect/dbfd8b004afe7d69bcb6bdb94e6f4d75/IFC_EMI_Survey_web.pdf?MOD=AJPERES> accessed on 08 December 2015

³² Ali Alp and Saim Ustundag, 'Financial Reporting Transformation: The Experience of Turkey' (2009) 20 *Critical Perspectives on Accounting* 680. See also Bernard Black, Antonio Gledson de Carvalho, Vikramaditya Khanna, Woonchan Kim and Burcin Yurtoglu, 'Which Aspects of Corporate Governance Matter in Emerging Markets: Evidence from Brazil, India, Korea, and Turkey' (2015) can be accessed < <http://ssrn.com/abstract=2601107>> accessed on 10 December 2015

asymmetric information. It aims to explore whether law reform, mainly laws on transparency and accountability, can lead to an increase in foreign investors in Borsa Istanbul.

3. Research Questions

The main purpose of this Thesis is to provide an analysis of the role of corporate governance in attracting foreign equity investment to the Turkish market. The low level of foreign investors indicates that Turkey faces a problem of investor confidence. The dominance of controlling shareholders in Turkish companies can be considered one of the main reasons behind this lack of investor confidence. Turkey's underperformance in attracting foreign investors can be related to the investors' perception of Turkey's corporate governance framework. Reference will be made to the Turkish business culture, which provides the ideal setting for examining the effect of corporate governance on foreign equity influx.

The first aim of this Thesis is to investigate whether corporate governance is a determining factor for attracting foreign equity investors to the Turkish capital market. Turkey reformed its Commercial Code in 2012.³³ It is a critical time to conduct this research as the main corporate governance innovations in the new Turkish Commercial Code (TCC) can now be assessed. The introduction of the new Code is likely to result in the further development of corporate governance in Turkey. If successful, the new Code will change the way Turkish companies perceive and implement corporate governance.

Provided that there is a positive relation between the quality of corporate governance and foreign equity investment, the present Thesis will move to analyse the novelties of

³³ The new Turkish Commercial Code Law No.6102 came into force on 1 June 2012

the new TCC in the area of corporate governance. Therefore, the second aim of this Thesis is to examine which novelties regarding corporate governance can have an effect on the perception of foreign investors. In particular, the Thesis investigates whether foreign equity investors have responded positively to the changes in corporate governance under Turkish law.

4. Methodology of the Research

Corporate governance is a complicated blend of law, finance, economics, accounting, administration, political science and ethics. Therefore, reports and studies from governmental institutions in Turkey and independent organizations, such as the International Finance Corporation, should be used along with principles and rules on corporate governance under Turkish law. The analysis includes economic and political factors and their effect on the regulation of corporate governance as well as its implementation. In addition to the analysis of positive legal rules, in Chapter 4 this Thesis examines how the law is applied in practice.

Empirical methodology will be used to answer the research questions.³⁴ The discussions on the economic significance of corporations, or on the law that affects them, should be supported by empirical analyses that point to the facts behind the law and the economic models.³⁵ The value of this approach derives from its connection with the law in practice. It is a means of evaluating the practical consequences of

³⁴ La Porta et al. (n. 6) is a turning point in corporate governance empirical research. Many scholars have used this approach as a tool for their corporate governance research. See Table 1 in Jiří Franek and Miroslav Hučka, 'Assessment Methods of Corporate Governance Systems: Factors, Indicators and Measures' in John Politis (ed.) *Proceedings of the 8th European Conference on Management, Leadership and Governance* (Academic Conferences Publishing International, 2012) 484-485 for a chronological summary of corporate governance empirical research. The work of Armour et al. has acknowledged the weaknesses, and disproved the claims, of the earlier works of La Porta et al. See John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems and Ajit Singh: 'Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis' (2009) 6(2) *Journal of Empirical Legal Studies* 343-380

³⁵ Jose M. Garrido, 'Optimism and Pessimism: Complementary Views on the Institutional Investors' Role in Corporate Governance' in Klaus J. Hopt, and Eddy Wymeersch (eds.), *Capital Markets and Company Law*, (Oxford University Press, 2003), 451.

law.³⁶ When it comes to the development of corporate governance, the challenge facing Turkey is of a dual nature: (1) harmonisation and fulfilment of the legal framework as a prerequisite to becoming a full member of the EU; (2) restructuring of investor confidence, in order to attract additional foreign investment. In order to achieve the first aim, reformed Turkish Company Law requires publicly held companies to give more detailed and easier-to-understand disclosure about deals between companies and proposes tougher penalties for breaking the laws. Thus, Corporate Governance principles have been regulated in the new Commercial Code and the requirements of Turkey's fulfilment of the legal framework to becoming a full member of the EU have been met.

The aim of improvements in the field of corporate governance is to protect the rights of the investors by increasing the transparency and accountability of the financial reports that are disclosed to the public by the companies and thus, to restructure the investor confidence. This is where the notion of investor perception becomes important. However, attempts to evaluate the reaction of investors to these improvements by looking at the law would not go beyond the descriptive analysis. Moreover, examining the new laws does not set forth a verifiable or refutable account on the perception of investors. Using an empirical method provides more precise insight into the effect of improvements on the perception of investors. It enables evaluating the practical consequences of the improvements in the field of corporate governance to restructure the investor confidence. For this reason, for the second challenge, empirical method is a necessity in order to assess the link between investors' reactions and legal improvements in the field of corporate governance.

³⁶ Marin Roger Scordato, 'Reflections on the Nature of Legal Scholarship in the Post-Realist Era' (2008) 48(2) Santa Clara Law Review 353, 410; and Joan MacLeod Heminway, 'Theoretical and Methodological Perspectives' in Thomas Clarke and Douglas Branson (eds.) *The Sage Handbook of Corporate Governance* (SAGE, 2012), 104.

Broadly speaking, empirical approach can be classified into quantitative and qualitative. Quantitative research is used to verify *what* is happening in a particular research area while qualitative research helps to develop new insights and offers important details on *why*.³⁷ The research questions, whether corporate governance is a determinant in attracting foreign investors to the Turkish capital market and whether the novelties of the new TCC had an impact on the perception of foreign investors, are fundamentally empirical. They focus on the relation between the corporate governance innovations of the new TCC and foreign investment. Therefore, quantitative empirical research has been chosen to go beyond descriptive analysis in finding the relation between the corporate governance innovations of the new TCC and foreign investment. The dataset provided by the Central Registry Agency for Turkey (CRA) will be used.³⁸

A criticism of empirical studies in the field of law is related to the fact that it may be problematic to numerically rank particular rules. For instance, what appears to be an identical rule works in a different manner between states, as it is impossible to isolate law from legal culture, and its general social, economic, and cultural background.³⁹

Thus, any attempt to understand the functioning of a legal system as a whole, needs to take into consideration the macro-system in which the law of a particular state works.

However, it is almost impossible to achieve this by numbers, or by statistical or

³⁷ Mike McConville and Wing Hong Chui (eds.) *Research Methods for Law* (Edinburgh University Press, 2007), 48.

³⁸ See Bengi Ertuna and Ali Tükel, 'Do Foreign Institutional Investors Reward Transparency and Disclosure Evidence from Istanbul Stock Exchange' (2013) 12(1) *Journal of Emerging Market Finance* 31, who provide empirical evidence from the Borsa Istanbul on the relationship between the level of foreign institutional investment and corporate governance. They use a unique data set made available by the Central Registry Agency for Turkey. See Sait Sevgener and Kadir Dabbağolu, 'The Effects of the New Turkish Commercial Code on the Transition of Capital Stock Companies to Corporate Governance' (2012) 2(4) *American International Journal of Contemporary Research* 116, where an empirical study is conducted on family-owned companies to reveal and explain on a statistical basis the relationship between the effectiveness of corporate governance and the legal regulations introduced by the New TCC.

³⁹ Mathias M. Siems, 'What Does not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology' (2005) 16(7) *International Company and Commercial Law Review* 300, 302

mathematical techniques. Thus, when it comes to empirical work in the field of law, it must be considered which conclusions can and cannot be drawn from numbers.

It is understood that investment decisions are made for a mixture of reasons. The corporate governance system of a particular company is only one. The corporate governance system may even play a secondary role in comparison with other factors, such as return on investment. One method of understanding the importance of the corporate governance system in investment decisions is through observing the numbers and percentages of investors purchasing shares in companies complying with corporate governance principles. The trend in the percentage of foreign investors investing in BIST-Corporate Governance Index is likely to directly reflect whether foreign investors place particular importance on the corporate governance practices of companies, because this is the index that includes companies applying CMB Corporate Governance Principles with a minimum rating of 7 over 10. Therefore, for the first research question, the number of foreign investors in BIST-Corporate Governance Index provides evidence for the importance foreign investors place on corporate governance in the Turkish market.⁴⁰ The data will be used to evaluate the importance foreign investors place on corporate governance, as it is indicative as to whether corporate governance does matter for foreign investors in Turkish capital market. Simple benchmarking of the change in the number of investors will be used instead of complex statistical analysis. Such an approach is more appropriate for this Thesis, as the research questions are more about understanding the importance foreign investors place on corporate governance in the Turkish market and less about the economic consequences of the increase in the amount of foreign investment influx.

⁴⁰ See Chapter 3 Section 1.3. pg 107 for details of BIST-Corporate Governance Index

In order to ensure that investment environment becomes more investor-friendly, Turkey has enacted a new Commercial Code. As the most significant piece of Turkish law, the new TCC aims to secure a more investor-friendly business environment in Turkey. Despite the fact that the legal framework is an important driver in shaping the trends of foreign investment, it may be misleading to claim that the increase in the number of investors has been caused purely by an improvement in the legal framework. The market can be affected by a number of different factors, political, economic, and corporate-related ones. However, the new Code constitutes a major reform in the area of Turkish commercial law and fundamentally changes the entire legal framework for the ways in which commerce and investment are carried out. Establishing such an investor-friendly environment is likely to result in a triggering effect on foreign investors, and lead to an increase in the volume of foreign equity investment influx to Turkey. As a legal improvement gains ground, following the enactment of the new TCC, foreign equity inflows are likely to maintain an upward trend in Turkish capital market.

The second research question does not take an interest in considering the behavioural explanation of individual foreign investors. The dataset provided by the CRA will be used to illustrate whether there is a reasonable upward trend following the enactment of the new TCC, of the number of foreign investors. While it is evident that the dataset does not directly reflect on ways in which the perception of foreign investors may have altered, an upsurge in the number of foreign investors is likely to indicate that the new Code has had a positive effect on the decision-making of foreign equity investors. If the data demonstrates an upward trend, it is likely to predict that foreign investors have welcomed the corporate governance innovations within the new code, bearing in mind that the new TCC is elaborated based on corporate governance principles. Due

to the lack of available data, it has not been possible to undertake a time-series analysis of equity investment trends in Turkey. Also, it is not possible to conduct a qualitative empirical research to verify the reasons behind every individual foreign investor's decision. Provided that there is an observable positive effect on the perception of foreign investors following the new legislation, then there will be a significant difference in the number of foreign investors between time t and $t+1$. For this reason, evaluating the difference in the number of foreign investors before and after the new commercial code by simple benchmarking is sufficient to reinforce the assessment of a causal relation.

This Thesis does, also, make use of a 'black-letter' research method on corporate governance, which includes a comprehensive review of statutory material, official documents, annual reports and online material, aiming at a critical assessment of the corporate governance rules and fundamental principles. Such material also provides valuable background information on the problems underlying corporate governance of Turkish companies. This Thesis is concerned with whether the recent modernisation activities in the new TCC have managed to improve the level of corporate governance for Turkish companies. In order to accurately reflect on the development of corporate governance framework and its interaction with the wider legal system, it is essential to discuss relevant legal improvements, i.e. the issuance of corporate governance principles of the Capital Markets Board of Turkey, and the enactment of a new TCC, in this field.⁴¹ Therefore, Chapter 4 aims at analysing whether the innovations on transparency and disclosure rules offer solutions to the problems of foreign investors.

⁴¹ Şirin Güven, 'Special Audit in Corporation Law, in accordance with Turkish Commercial Code No. 6102' (2011) 7(2) CankayaUniversity Journal of Law at 133-175 and Hasan Pulaşlı, 'Elektronik Ortamda Anonim Şirket Genel Kuruluna İlişkin Düzenlemelerin Evrimi ve 6102 Sayılı Türk Ticaret Kanunundaki Durumu' (Evolution of the Regulations Relating to the General Assembly in Electronic

As mentioned earlier, the Thesis will engage with a wide range of primary and secondary sources. The previous as well as the new TCC, the Turkish company and capital markets laws serve as a starting but also focal point for the discussion throughout the Thesis.⁴² The corporate governance principles of the Capital Markets Board of Turkey will also be examined in detail, especially for the purposes of Chapter 3, where the discussion focuses on how these corporate governance principles have acted as a driver for the development of corporate governance in Turkey.

Information has also been drawn from previous studies conducted in the field of corporate governance as well as other secondary sources, such as communiqués and declarations of the Capital Markets Board, periodical articles, books, reports and web sources.

5. Structure of the Thesis

Following this introduction, Chapter 1 explains the legal issues associated with equity investment, such as the nature of ownership, characteristics of financial markets and financial market instruments. Equity investment will be elaborated to provide a basis for the relationship between equity investment and corporate governance. Having defined foreign equity investment, the chapter will move on to describe in greater detail the evolution of equity investment and the formation of the stock exchange in Turkey, starting from the last period of the Ottoman Empire. The chapter will set out the legal dimension of foreign equity investment under Turkish law and look at how

Media and Their Status in the Turkish Commercial Code No. 6102) Elektronik Nehir Dergi Halil Arslanlı Bilim Arşivi <<http://arslanlibilimarsivi.com/sites/default/files/makale/HasanPulasli-internetOrtamindaGenelKurul.pdf>> accessed on 25 May 2015 are examples of studies that assessed the new TCC using non-empirical research methodology.

⁴² See The new TCC Law (n. 32) and Capital Market Board of Turkey, Capital Market Law No. 2499 (30 July 1981) (obsolete), Capital Market Board of Turkey, Capital Market Law No. 6362 (30 December 2012) can be accessed from < <http://www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=1&pid=1&submenuheader=-1>> accessed on 15 June 2015

laws and regulations regarding foreign capital have had an effect on attracting foreign investment into Turkish capital market. The chapter will seek to explain the need that the Turkish economy has for foreign capital. Finally, the role of corporate governance in foreign equity investment will be examined.

Chapter 2 provides an overview of corporate governance. The meaning of corporate governance cannot be properly explained without understanding the history behind the formation of the company and the development of limited liability. It will then go on to consider the agency theory, which is associated with companies in which ownership is separated from control. Following this background information, this chapter will argue against the view that corporate governance is not a pivotal issue in family controlled companies since agency conflicts do not pose a problem where a concentrated ownership structure dominates. It will attempt to show that family controlled listed companies may face their own set of agency problems. Lastly, the chapter intends to explain the emergence of corporate governance in family controlled Turkish firms. Several determinants have proven to be important in shaping companies' corporate governance structures.⁴³ Heavy government intervention in business activities affects the complexity of organizational structures, the level of transparency and the corporate governance structure of companies. Ownership structures determine the nature of the relationship between the owners, managers and investors and, thus, the corporate governance structure. This chapter will attempt to trace back the ownership structure of Turkish companies and explain why families are the dominant shareholders in this structure. This chapter lays the foundations for the next two chapters.

⁴³ See Joseph P.H. Fan, K.C. John Wei and Xinzhong Xu, 'Corporate Finance and Governance in Emerging Markets: A Selective Review and an Agenda For Future Research' (2001) 17 *Journal of Corporate Finance* 207.

Turkey regulates its corporate governance framework through the Capital Markets Law and the Corporate Governance Principles of the Capital Markets Board of Turkey. The new Turkish Commercial Code (TCC) also includes corporate governance principles. The main objective of Chapter 3 is to examine whether these amendments in the new TCC represent a sign of development in corporate governance in the sense of better implementation and enforcement. In this respect, the chapter will start with an overview of the corporate governance activities carried out in Turkey. It will outline how the Organization for Economic Cooperation and Development (OECD) corporate governance principles have acted as a driver for the development of corporate governance in Turkey. The chapter concludes with an examination of the effectiveness of the state's policy-making function in corporate governance under the new TCC.

Chapter 4 will investigate the relationship between corporate governance and foreign equity investment to determine whether or not corporate governance has been a factor in attracting foreign investors into the Turkish capital market. It explores the relationship between foreign equity investment and corporate governance in the Turkish market by presenting evidence from the Turkish Investor Relations Association and Central Registry Agency. This chapter will also discuss in detail the articles of the new TCC that affect the notion of investor perception. It will focus on the regulations that increase the transparency and accountability of the companies. Therefore, Articles of the new TCC that are related to the right to obtain information and inspection, group of companies and the use of information technologies will be discussed.

Finally, Chapter 5, the concluding chapter provides a brief summary of the main arguments made throughout the Thesis and reflects on the key points in relation to the research questions.

Chapter 1

FOREIGN INVESTMENT AND ITS LEGAL ENVIRONMENT IN TURKEY

Introduction

Financing is the act of providing capital to businesses. A business can finance its operations in two ways: by rising funds either internally or externally. Internal funds are profits that are generated and reserved in the company rather than distributed to owners of the company. One of the ways to generate external funds is to offer investors a residual claim on the cash flows by issuing shares.¹ As businesses develop, they tend to rely more on external financing. Therefore, large-scale corporations generally rely on finance increased through investments.² Thus, the financing of corporations and investment are inextricably linked with each other.

The nature of investment and the process of investing present a complex picture. The definition of investment depends on the context in which the term is being used. The rate of return on invested capital and risk are the main aspects of investment. Investors place their capital where they can understand the risks and believe that their capital is protected from misuse.³ In investment environments where trust is low, the risk of loss of investment income increases.⁴ Consequently, regulations related to investment have become an important influence in the process of investing because it is commonly associated with trust.

¹ Aswath Damodaran, *Applied Corporate Finance* (3rd edn. Wiley, 2010) 2

² Iain G. MacNeil, *An Introduction to the Law on Financial Investment* (Hart Publishing 2005), 207.

³ Ira M. Millstein and Holly J. Gregory, 'Corporate Governance Reform: Learning from our Mistakes' in Peter K. Cornelius and Bruce Kogut (eds) *Corporate Governance and Capital Flows in a Global Economy* (OUP, 2003), 495.

⁴ Paul J. Zak and Stephen Knack, 'Trust and Growth' (2001) *The Economic Journal* 11(470) 295, 305-307.

The purpose of this chapter is to provide an understanding of how the scope of foreign equity investment in Turkey has evolved. The term ‘equity investment’ is defined in the economic context as the term is often used there. However, the legal context of equity investment is relevant to the subject of investment as well as to the economic context. In the legal context, equity investment is a property, and the legal view of investment is that it is intrinsically linked with the laws associated with ownership of that property.

The economic approach to investment distinguishes investment in real assets from investment in financial instruments, such as shares and bonds. This chapter starts with the definition of equity investment. From a very general standpoint, the notion of corporate governance deals with the direction and control of companies to ensure that investors get a return on their investment.⁵ In equity investment, most investors do not have direct control over the management of a company because they generally hold only a small number of shares.⁶ Therefore, this control is given to managers.⁷ They can only obtain the information disclosed to them and they cannot ensure that the decisions taken by the managers are beneficial for the company.⁸ Thus, managers may have more information about the company than investors.

⁵ Andrei Shleifer and Robert W. Vishny, ‘A Survey of Corporate Governance’ (1997) 52(2) *Journal of Finance* 737, 737, and Benjamin E. Hermalin, ‘Corporate Governance’ in Robert Gibbons and John Roberts (ed.), *The Handbook of Organizational Economics* (Princeton University Press, 2013), 734.

⁶ A fundamental issue concerns the fact that no individual is in possession of sufficient incentive to devote resources to ensuring that managers act in the best interests of the company. While individual shareholders must bear all the costs of monitoring, they share the benefits with all of the shareholders, so are unable to benefit from all the gain. Considering the cost of monitoring, each shareholder will free-ride in the hope that other shareholders will undertake any necessary monitoring. See Sanford J. Grossman and Oliver D. Hart, ‘Take-over Bids, the Free-Rider Problem, and the Theory of the Corporation’ (1980) 11(1) *Bell Journal of Economics* 42

⁷ Chapter 2 provides a detailed discussion of separation of ownership and control pg. 67

⁸ Kathleen M. Eisenhardt, ‘Agency Theory: An Assessment and Review’ (1989) 14(1) *The Academy of Management Review* 57, 61

Corporate governance aims to provide investors with adequate and accurate information regarding corporations' performance, liabilities and ownership issues.⁹ This information is critical for equity investors to understand the economic picture of the company and make any investment decisions and judgments on the risks. The strength of transparency in corporations and the quality of public disclosures are becoming significant for investors because they are increasingly paying attention to what is reported and how.¹⁰ Companies with weak corporate governance lack financial disclosure and transparency.¹¹ The quality of corporate governance is of particular importance for equity investors, because corporate governance goes hand in hand with increased transparency and accountability, which can result in increased trust and confidence in the market. Thus, corporate governance has become a crucial tool in maintaining transparency by good reporting practices and aiding investors to obtain comprehensive, reliable and timely information regarding the financial performance and non-financial conditions of companies. Given that equity investors take the view that companies with effective corporate governance are less risky, it is essential to improve their corporate governance standards in order to attract equity investment.

This chapter will be a basis on which the relationship between equity investment and corporate governance will be shown. The next section will attempt to examine the legal issues associated with equity investment, such as the nature of ownership and financial market instruments. An overview of the framework follows below.

⁹ See OECD Corporate Governance Principles, <<http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf>> accessed on 14 June 2015, Part 5 Disclosure and Transparency, 49-57

¹⁰ Benjamin Fung, 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) 2(2) *Universal Journal of Management* 72, 72

¹¹ Wendy Beeks and Philip Brown, 'Do Better-Governed Australian Firms Make More Informative Disclosures?' (2006) 33(3-4) *Journal of Business Finance & Accounting* 422, 445-446

Having defined the term foreign equity investment, this section moves on to describe in greater detail the evolution of equity investment in Turkey starting from the last periods of the Ottoman Empire. The most important legal rules regarding foreign equity investment inflow to Turkey will be examined. This part illustrates the historical and regulatory reasons for the late progress of Turkish capital markets and the stock exchange. Previously rules prohibited the influx of foreign equity investment to the Turkish capital market. Additionally, the late establishment of a stock market resulted in a corporate culture in which companies were financed internally and dominated by a group of shareholders. Therefore, the concept of equity investment is not fully established in Turkish business culture, and it has not been able to attract the attention of investors. Furthermore, today, Turkey is in need of foreign capital to increase its growth performance. In this connection, corporate governance can be crucial in increasing transparency, accountability, fairness and responsibility in the investment environment. In this way, Turkish companies are likely to attract more foreign investors if they can decrease investment risk by corporate governance.

1. Foreign equity investment

The Turkish Commercial Code Law No. 6102 provides a general framework for all commerce-related activities.¹² However, due to its comprehensiveness, it is at times incapable of satisfying the needs of commercial life. Very little can be found on the question of who can be an investor under the TCC. To remove the deficiencies, more detailed provisions have come into force over time. The term ‘investor’ is used in

¹² See The Republic of Turkey Turkish Commercial Code Law No. 6102 (31 January 2011)

other more specific investment laws.¹³ These laws on investment determine the kind of individuals and legal persons that can benefit from the investment.

Investment takes different forms in the economy today. The developments in the business world, such as the replacement of import-substitution policies¹⁴ in open economies in large parts of the developing world after the early 1980s, made capital more mobile compared to the previous century.¹⁵ This enabled states to reduce their trade barriers and open their capital accounts.¹⁶ This resulted in the economic integration of markets, production, technology, corporations and industries. This integration triggered cross-border movement of goods and services, technology, and capital. After these developments, investors had easier access to foreign markets and they had different options for investment. Following that, foreign investment became part of a broader interest in the forces driving the integration of the world economy.

Foreign investment is the flow of capital from one state to another in exchange for ownership in domestic companies or other domestic assets. It can be divided into two main sub-groups: direct and equity investments.¹⁷ Lipsey defined equity investment as the type of investment that takes place in the financial markets and covers shares and debt securities, where there are ‘many buyers and sellers competing with each other to

¹³ See Foreign Direct Investment Law Of Turkey Law No. 4875 (5 June 2003) Article 2(a)

¹⁴ Import substitution is an industrialisation strategy that induces to produce products, which were exported before, by protective measures and incentives in the state instead of exporting.

¹⁵ WTO, ‘Trade and Foreign Direct Investment’

<http://www.wto.org/english/news_e/pres96_e/pr057_e.htm> accessed on 23 June 2015

¹⁶ Capital account is a receipt of foreign private and public lending and investment in excess of repayment of principal and interest on former loans and investments

¹⁷ Itay Goldstein and Assaf Razin, ‘Foreign Direct Investment vs Foreign Portfolio Investment’ (2005) NBER Working Paper Series Working Paper 11047, 2

supply or acquire fairly standardised types of assets with fairly well-defined prices' with the prospect of providing more consumption in the future.¹⁸

In the case of economic instability, equity investors may withdraw their investment easily. This structure of equity investment makes it the most volatile and reversible of all major types of capital flows. Therefore, there is a greater possibility for flight of capital. States with an economy, which depends heavily on investment in securities, need to be able to prevent the 'departure' of capital in order to avoid an economic crisis. Corporate governance may serve an important purpose in preventing this departure by ensuring a reliable and secure investment environment.

Following the emergence of the joint-stock company in the early 19th century, companies began to increase their size of membership relative to that of their predecessors. This led to them becoming essentially impersonal organisations, with the majority of their shareholders no longer having any participation in management.¹⁹ The majority of joint stock company shareholders relinquished all rights to operate and manage, thus becoming functionless 'investors,' that is taking little direct interest in the companies in which they held shares, other than the dividends paid.²⁰ An important consequence of this relinquishment of management by shareholders is that equity investment has a purely financial character. Most individual equity investors are passive and do not have control power over the management of the invested company. Regardless of any control over the company, they focus more on the value

¹⁸ Robert E. Lipsey, 'The Role of FDI in International Capital Flows' (1999) in Martin Feldstein (ed.), *International Capital Flows* (University of Chicago Press) 308, Richard Pike and Richard Dobbins, *Investment Decisions and Financial Strategy* (Philip Allan, 1986) Chapter 3, 25-26, MacNeil (n. 2) 4-5

¹⁹ Paddy Ireland, 'Defending the Rentier: Corporate Theory and the Reprivatisation of the Public Company' in John Parkinson, Andrew Gamble and Gavin Kelly (ed.) *The Political Economy of the Company* (Hart Publishing 2000) 146

²⁰ Ibid 147

of their capital and the return that it can generate.²¹ Instead of playing an active role, they have to rely on decisions that managers make for the company. Investors expect managers to make decisions in the best interest of the company and to maximize their returns. However, this expectation may not always be met because the expectations of the investors can be different from that of the managers.²² Conflicts of interest between the investors and managers of the company can always arise. Corporate governance supports the accurate and timely disclosure of relevant, sufficient and reliable information to the public, including the financial performance, ownership structure, and governance which enables all investors to be well informed about the company.²³ In this case, corporate governance becomes important for equity investors, as it can lower the potential information asymmetry between the managers and investors.

Equity investment becomes foreign investment, when it takes place in foreign markets rather than in domestic ones. The legal rules regarding equity investment will be comprehensively discussed in order to clarify the reasons for defining it as above. The aim of this chapter is to illustrate the theoretical background of foreign equity investment. Therefore, investment types other than foreign equity investment will not be dealt with here.

²¹ UNCTAD, 'Scope and Definition: UNCTAD Series on Issues in International Investment Agreements II' (2011) < http://unctad.org/en/Docs/diaeia20102_en.pdf > accessed 17 June 2015, 29

²² See Chapter 2 Section 1.2 pg. 69, See also Holger Kraft and Ralf Korn, 'Continuous-Time Delegated Portfolio Management with Homogeneous Expectations: Can an Agency Conflict be Avoided?' (2008) 22(1) Financial Markets and Portfolio Management 67, 68

²³ OECD (n. 9) Part V-Disclosure and Transparency

2. Legal regulation of equity investment

The definition of equity investment, as given above, focuses on investment as a property with its own legal rules related to the ownership of that property.²⁴ Inherently, the legal and economic views are linked to each other.²⁵ Shareholders are deemed to be simply providers of capital, and are viewed as residual claimants, entitled to any surplus, which is not precisely specified.²⁶ Thus, they cannot easily protect themselves by contract, and accept the risk associated with their residual position.²⁷ The fundamental challenge of the rules is to provide a clear nature of the claim of each investor, and to create available enforcement procedures that will provide consistent enforcement of such claims.²⁸ Without this protection of rules granting them voting rights, and compelling managers to act in the best interests of the company, savings are unlikely to be channelled into investment.

A contract is the primary mechanism that creates rights and obligations for the subjects of equity investment.²⁹ Investors own a property by virtue of a contract. Ownership can be defined as the legal rights given to an owner in respect of a thing.³⁰ These things can be grouped in two categories: tangible things that have a physical form such as a painting; and intangible things that do not have a physical nature, such as copyright on a painting. Tangible things can be further divided into real assets and personal assets. Real assets consist of land and buildings while personal assets refer to

²⁴ Property is used as any tangible or intangible assets over which a person or business has legal title.

²⁵ MacNeil, (n. 2) 4

²⁶ Ireland, (n.19) 166, Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' 26 *Journal of Law and Economics* 301, Daniel J. H. Greenwood, 'The Dividend Problem: Are Shareholders Entitled to the Residual?' (2006) 32(1) *Journal of Corporation Law* 104-159, Lynn M. LoPucki, 'The Myth of the Residual Owner: An Empirical Study' (2004) 82(4) *Washington University Law Quarterly* 1341-1374

²⁷ Ireland, (n. 19) 166

²⁸ MacNeil, (n.2) 8

²⁹ Ibid

³⁰ See 'General Legal Concepts' para 1097 for meaning of 'things' in this context in Robert Black, Joseph M. Thomson and Kenneth Miller, *The Laws of Scotland, Stair Memorial Encyclopaedia* (Butterworths, 1990) Vol. 11

all the other type of property. By law, equity investments fall under the category of intangible personal assets.³¹ A physical asset cannot be identified in equity investment.

Financial markets work most effectively when information is provided in an orderly and timely manner, along with the presence of investors who are fully informed, and markets are free of manipulation.³² Shareholders receive dividends at the discretion of the directors. They have voting rights, but these may be ineffective as a result of any delay in the disclosure of information, or the information provided being inaccurate. Moreover, small shareholders have little incentive to maintain their information concerning the company, or to exercise their rights,³³ thus leading to the need for regulators to require companies to disclose information fully.

In the absence of such regulations, shareholders may find it difficult to remedy this information asymmetry, and secure a proper return on their investments. The products traded in the financial markets are of an intangible nature, and are without value in the absence of an effective legal framework.³⁴ Consequently, in the absence of regulation, the legal validity of intangible items can be threatened. Thus, the markets need to be regulated, due to a failure of the markets to offer the necessary protection to investors, and ensure they are able to get a return on their investment.³⁵ Regulation is a means of ensuring fairness in markets, and protecting investor value in their operations, and thus regulation results in a greater willingness of individuals to invest.

³¹ MacNeil (n. 2) 9

³² Peter D. Spencer, *The Structure and Regulation of Financial Markets* (OUP 2000) 113

³³ Oliver Hart, *Firms, Contracts and Financial Structure* (Clarendon Press, 1995) 127

³⁴ Roger McCormick, *Legal Risk in the Financial Markets* (2nd edn. OUP, 2010) 13

³⁵ Paul Barnes, *Stock Market Efficiency, Insider Dealing and Market Abuse* (Gower Publishing 2009) 113

Over the past decades, investors have witnessed a considerable number of financial scandals caused by the opacity of financial markets, leading to a need for their trust to be restored. Market forces direct companies to act in a manner deemed to be in the best interests of investors. However, market pressure may not always exist at the same level.³⁶ Thus, corporate governance as a legal framework is relevant for investors, because it helps to deliver confidence in investors by increasing the certainty of financial markets, through transparency and reporting obligations. Between trust in markets, and increased corporate governance regulation, the relationship is not always in an equative correlation. This means that on the one hand lower levels of regulation would be unable to achieve trust, but on the other hand regulation by itself is unable to build trust. To give an example, transparency is one of the first issues to arise at the mention of corporate governance. Strict rules concerning transparency need to be in force, in order to allow investors to obtain sufficient information concerning the company in which they are investing.³⁷ However, rules concerning transparency, cannot, in isolation, become a panacea. Transparency refers to an increase in the quality, rather than the quantity, of information. Thus, the focus of regulations should be on the provision of the foundations for obtaining the correct information, instead of simply putting strict rules on transparency in place.³⁸ It should also be considered that increased regulation is unlikely to prove effective on its own, as it also needs to be enforced. While deciding on the appropriate extent of regulation, it is important to assess whether an increased burden of compliance is helpful to both investors and companies. Effective rules are required to improve the standard of corporate

³⁶ Thomas Clarke, 'Markets, Regulation and Governance: The Causes of the Global Financial Crises' in Thomas Clarke and Douglas Branson *The Sage Handbook of Corporate Governance* (Sage Publications, 2012), 533-556

³⁷ Fung, (n.10), 76

³⁸ International Corporate Governance Network (ICGN), 'Financial Market Regulations: Time for a Holistic Review?' available in the website: < <https://www.icgn.org/financial-market-regulations-time-holistic-review> > accessed on 20 November 2015

governance. However, it is a simplification to assume that the issues related to corporate governance will be resolved by regulation alone. Should this be true, there would have been a lack of any corporate scandals following the enactment of corporate governance regulations.

Corporate governance rules create a pathway, and companies are advised to follow. For this reason, regulation is only able to give investors confidence if they have a positive effect on corporate culture. If rules fail to change corporate culture, then many corporate governance regulations are irrelevant. The outcome of corporate governance regulation which is unsuitable for the ways companies make business will not restore investor confidence because a number of these regulations will not be implemented.

The basis of a successful and stable regulated financial system consists of the relationship between market participants, regulators, and those responsible for the application of the law in market transactions.³⁹ Thus, regulation is, to a certain degree, necessary for the enhancement of corporate governance principles, particularly as corporate governance has become an issue related to foreign investors. These principles have the ability to bridge the confidence gap. However, the notion that imposing additional regulation leads to improved functioning of financial markets only demonstrates the unrealistic expectations of the potential achievements of regulation. States' legal environment and the way companies do business should be the main determinant when deciding on the appropriate degree of regulation for individual states, as there is no code that applies to all states. It should be noted that regulations unsuited for business culture can potentially threaten the reliability of the

³⁹ McCormick, (n. 34), 4

market, and produce unacceptable peril for businesses, along with risks that can deter the entrance of new markets.

Transactions in the financial market are carried out through financial instruments. A financial instrument, which represents the right to acquire future benefits under a stated set of conditions, is a legal contract. In general, there are two types of stock market securities: fixed-income instruments and variable-income instruments.⁴⁰ Fixed-income instruments provide a fixed return in periodic payments and the eventual return of principal at maturity. A bond is a security issued in connection with a borrowing arrangement.⁴¹ This security group is composed of Treasury notes and bonds, corporate bonds, municipal bonds, mortgage securities and federal agency debt.⁴² A convertible bond is one that can be converted by the holder into ordinary shares. They give investors the option to buy or sell a predetermined number of shares at an agreed price, within a certain period, or on a specific date.⁴³ As a hybrid financing instrument, it is a financing tool which acts as both debt and equity. It has relatively lower interest cost than bonds and bears less risk than equity finance as well.

The emergence of convertible bonds can alleviate the deviation in the interest of the investors than the interest of agent because should the performance of the company prove to be poor, such a conversion does not take place, and investors get the return of bond.⁴⁴ This allows investors to get informed how the company operates in a certain time and then decide whether or not to make the conversion. Thus, investing in

⁴⁰ See Zvi Bodie, Alex Kane and Alan J. Marcus *Essentials of Investment* (9th edn. McGraw-Hill Irwin, 2013) 31-37

⁴¹ Ibid

⁴² Ibid

⁴³ Ibid 470

⁴⁴ Fischer Black and Myron Scholes, 'The Pricing of Option and Corporate Liabilities' (1973) 81 *Journal of Political Economy* 637

convertible bonds limits investors' downside risk at the expense of limiting the upside potential. A stock warrant has similarities to convertible bonds, giving the investor the right to buy an underlying security at a certain price, quantity and future time.⁴⁵ As the majority of these instruments promise a fixed stream of income, the investment performance of these securities is not closely related to the financial condition of the issuer as it is in case of variable-income securities.

In contrast to fixed-income securities, equity stocks are a kind of variable-income securities.⁴⁶ Equity investors are not the legal owners of the profits, but are in fact residual claimants, who receive a net income after deducting all costs. Equity stocks give investors the right to have an ownership claim on the earnings and assets of corporations. Corporations do not promise any determined payment to the shareholders in advance. Instead, the investors receive any dividends the firm pays.⁴⁷ Ordinary shares are generally entitled to one vote per share, and to an equal share of dividends.⁴⁸ Ordinary shares have a lower priority when it comes to company assets, and only receive dividends at the discretion of the corporation's management. A further common type of share is a preferential share. Preferred shares are included in the fixed-income category of investment instruments, although they are considered to be equity.⁴⁹ Preferred shares have a preferential right to a fixed amount of dividend, and have the advantage of a higher priority claim to the assets of a corporation in the case of insolvency. However, owning preference shares still does not guarantee the payment of a dividend. The return of variable income securities varies based on

⁴⁵ Bodie, Kane and Marcus (n. 40) 602

⁴⁶ Ibid 32

⁴⁷ Fama and Jensen, (n. 26) 301, 302

⁴⁸ Stephen Bloomfield, *Theory and Practice of Corporate Governance: An Integrated Approach* (CUP, 2013) 94

⁴⁹ Bodie, Kane and Marcus (n. 40) 471

changing conditions, such as the performance of the company. This means that the profits of investment in these securities are tied to the success of the corporation.

Investors obviously aim to maximize their returns.⁵⁰ They appoint managers and they are given substantial discretion to make the important decisions about the company. However, these managers are not major residual claimants. Bearing in mind that the expectation of managers may be different from that of the investors, managers may take actions that are advantageous to the company, but detrimental to investors. As a result, the return of their decision may not affect the managers in the same way that it affects the investors. The costs that investors bear to monitor the decision-making process is a crucial determinant for investment decisions because monitoring costs are a source of economic loss for investors. To enable monitoring, common stocks usually give some rights to make specific claims to its holders.⁵¹ Holders generally have the right to attend, speak, vote in the general meetings and participate in the general policy-making of the corporation. They are able to appoint the board of directors and can require external auditors to verify financial reports. Corporate governance has become a crucial tool in reducing the monitoring costs for investors as it assists in ensuring that an adequate and appropriate system of control operates within companies.

A well-functioning local financial market will attract foreign equity investors. Turkey has tried to benefit from foreign capital by performing financial liberalization in the 1980s. The next section will illustrate the previous and current regulations regarding equity investment in Turkey with a brief history of foreign investment in Turkey. This

⁵⁰ John Sloman and Alison Wride, *Economics* (7th edn. Pearson Education Limited, 2009) 216

⁵¹ IMF, Handbook on Securities Statistics. Part 3, Equity Securities, 3.9(a)(b)(c)

will be helpful to understand better the reasons for the slow development of the Turkish capital market.

3. Formation of stock exchange in Turkey

Even though the Turkish Republic is only 90 years old, foreign investment has a history of more than 150 years, having started in Turkey for the first time during the Ottoman Empire era. The economic policy that the Ottoman Empire applied in that period had an impact on the influx of foreign investment. In the last years of the Ottoman Empire, the economy was in need of financial resources because it had external debts. Until the 19th century, the Ottoman Empire used taxes as a key solution to its financial problems. However, at the beginning of the 1840s the taxes became insufficient. For the first time, foreign equity investment inflow took place in the 1840s with the sale of short-term bonds to French banks.⁵² In the 1850s, foreign capital became a more preferable way to find solutions to financial problems and other European states offered other financial securities besides bonds. In addition, European investors, who were interested in directly investing into Turkey, applied for permission to establish joint stock companies.⁵³ These joint stock companies, which were established in Turkey, invested in railways, water and gas facility buildings.⁵⁴ Foreign investment in that era of the Ottoman Empire was mostly direct investment for the infrastructure of production activities. The Industrial Revolution in the 19th century in Europe increased the number of joint stock companies. The Ottoman Empire was in a declining stage and there was lack of knowledge and financial power

⁵² Sefer Şener and Cüneyt Kılıç, 'Osmanlıdan Günümüze Türkiye'de Yabancı Sermaye' (Foreign Capital in Turkey: From Ottoman Empire to present) (2008) 10(1) Bilgi Dergisi 22, 23 and Sevket Pamuk, *Osmanlı-Türkiye İktisadi Tarihi 1500-1914 (Ottoman-Turkey Economic History, 1500-1914)* (Gerçek Yayıncılık, 1997) 187-188

⁵³ Pamuk ibid 192

⁵⁴ Yakup Kepenek and Nurhan Yentürk, *Türkiye Ekonomisi (Turkish Economy)* (Remzi Yayıncılık, 2001) 11

to keep up with the developments around the world. The economic activities on which the Ottoman Empire based its economy were mainly agriculture, craftsmanship and imports. Therefore, since the number of companies issuing shares was limited, there was not a great need for capital markets in the Ottoman Empire. Bonds issued by the Empire were the most important securities. Most of these bonds were sold to European investors by Galata bankers.⁵⁵

The Galata Exchange, which was formed in the last quarter of the 19th century, is considered to be a very important development, because it is one of the first attempts to create portfolio investments. Initially, it was formed as an ‘over the counter’ market and operated on an ad hoc basis without a central regulation or location. The rapid improvement of the European exchanges had a significant effect on the establishment of this exchange.⁵⁶ Shares and bonds issued by joint stock companies in Europe started to be traded by Turkish citizens and bonds issued in Turkey were traded in European exchanges. In this way, the idea of a regulated exchange market in the Ottoman territory emerged.

The first formal exchange of the Ottoman Empire in domestic and foreign stocks took place in 1866.⁵⁷ Even though a regulated exchange was formed, the key problem was that the stock exchange could not become an element of the national economic policy and, as a result, did not support the industrialization process in the Empire. Ultimately, the severe effects of World War I and the Independence War of Turkey destroyed the economy. The declaration of the Republic brought in new legislation. Privileges given

⁵⁵See Murtaza Köse, ‘Osmanlıda Borsa ve Galata Bankerlerinin Devletin Mali Yapısındaki Yeri’(Stock Exchange in Ottoman Empire and the Status of the Galata Bankers in State’s Fiscal Structure’ (2001) 8(18) Atatürk Üniversitesi Türkiyat Araştırmaları Dergisi 229 for detail information of Galata Bankers

⁵⁶ Ibid 232

⁵⁷ See Mehmet Başirli, ‘Osmanlı’da Borsa: Dersaadet Tahvilât Borsası’ndan Eshâm Ve Tahvilât Borsası’na Yeni Düzenleme Girişimleri’ (Stock Exchange in the Ottoman State: New Regulatory Attempts to the Stock Exchange of Debenture Bonds and Shares from the Stock Exchange of Debenture Bonds of Dersaadet) (2009) 19(1) Fırat University Journal of Social Science 185

to foreign states by the Empire were removed and foreign companies were nationalized.⁵⁸ All these had a negative effect on the economy. In 1930, the Great Depression broke out. State economies and stock markets collapsed during the Great Depression. A consequence, there was a change in the exchange rates. The Turkish currency depended on the British pound on the free exchange rate system and the Turkish lira depreciated against it. This had a serious effect on the Turkish economy as the debt from imports increased. As a result of such fluctuations led to currency depreciation in the Turkish economy, the economy went from bad to worse, even though Turkey was an agricultural state with a smaller sized foreign trade.⁵⁹ Due to the fluctuations in the economy, the state began to intervene in the economy by putting new rules on exchange control.⁶⁰ In order to protect its value, Law No.1567 on the Protection of the Value of Turkish Currency came into force. The new law illegalized the buying and selling of foreign currency and securities in the free market. This brought transactions with foreign currency to an end and the stock exchange lost its foreign capital accumulation role. In spite of taking over a comparatively open economy from the Ottoman Empire, the state introduced restrictions on foreign currency. However, this could not prevent fluctuations in the economy and the value of the Turkish currency continued to depreciate.

In 1960, the Exchange was resuscitated with the issuing of saving bonds. However, in the 1980s these bonds were withdrawn from the market.⁶¹ Nevertheless, the necessity of a securities market for the economy was not ignored. A new system was sought and

⁵⁸ Abdullah Takim and Ensar Yilmaz, 'Economic Policy During Ataturk's Era in Turkey 1923 – 1938' (2010) 4(4) African Journal of Business Management 549, 551

⁵⁹ Currency depreciation is the decline over time in the value or price of one currency in terms of another as a result of market forces of supply and demand

⁶⁰ Marketable Securities and Foreign Exchange Markets Law No.1447 brought limitations to the market

⁶¹ Barbaros Yalçiner, 'SPK ve Türk Sermaye Piyasaları' (CMB and Turkish Capital Markets) < http://www.aktuerya.hacettepe.edu.tr/duyurular/seminerler/risk_gunleri/6.pdf> accessed on 25 July 2015, 15

in order to regulate and audit all capital markets, the Capital Markets Board was established.⁶²

Turkey generally provides an appropriate setting to address the presence of two opposing forces. On the one hand, there are the forces of financial integration, and the ensuing corporate governance mechanisms supporting the view that stock markets provide a market for corporate control. On the other hand, there are country-specific practices that may eschew shareholder rights.⁶³ However, this brief history of the Turkish stock market shows that Turkey could not benefit from the monitoring role of the stock market until the 1990s. Instead, banks undertook the role of providing finance to the private sector. Even though the Turkish banking sector plays a vital role in the economy, it does not perform a monitoring role when it comes to company management. This lack of monitoring leads to potential issues of expropriation. The corporate governance practices of Turkish companies gain in salience as foreign investors arrive in search of new opportunities. Thus, the importance of having corporate governance practices in place is becoming more pronounced.

Despite the late establishment of the stock exchange of Turkey, rapid improvement was achieved in order to catch up with the developments in stock markets in developed states. A large number of laws and regulations were brought in to regulate and improve the stock market environment. In general, there was no discrimination between foreign investors and domestic investors. However, there were a few regulations affecting foreign equity investment inflow into Turkey, which need further examination for the better understanding of the current situation regarding foreign

⁶² See Chapter 3 Section 1.1 pg. 95

⁶³ Turhan Kaymak and Eralp Bektas, 'East Meets West? Board Characteristics in an Emerging Market: Evidence from Turkish Banks' (2008) 16(6) *Corporate Governance* 550, 551

investment. The TCC and Corporate Governance Principles also apply to foreign investors and more detail will be provided in Chapter 3.

4. Laws and regulations regarding foreign equity investment in Turkish Law

Even though the first legislation, which is directly related to foreign investment in Turkey, was the law of foreign investment incentives which came into force in 1954, it is clear that the law on the protection of the value of the Turkish currency had much more serious effect on foreign investment.⁶⁴

The Republic of Turkey was proclaimed after the independence war of Turkey. According to the peace settlement treaties, the new government had to pay most of the debts of the Ottoman Empire. However, the economy of the new Republic was not strong enough to pay all the debts. Production and industry sectors were very limited and exporting was almost non-existent. Agriculture was the main source of income but farming methods were extremely old-fashioned.⁶⁵ The nationalization of foreign corporations in Turkey resulted in foreign investors leaving the state. In the first years of the Republic, the lack of domestic private capital necessary for economic development triggered the need for foreign capital.

The law on the protection of the value of the Turkish currency is considered to be the turning point of foreign exchange control. Convertibility of the Turkish currency was removed by this law.⁶⁶ As a result, the transactions of foreigners were restricted and subjected to permission from the Council of Ministers.

The law on the Protection of the Value of Turkish Currency has had significant negative effects on both the financial and foreign investment environment of Turkey.

⁶⁴ The Republic of Turkey, Foreign Investment Incentives Law no. 6224 (18 January 1954)

⁶⁵ Aykan Candemir, *Türkiye’de Doğrudan Yabancı Sermaye Yatırımlarını Etkileyen Faktörler: Bir Uygulama Vol.2 (Factors Effecting the FDI influx to Turkey: An Application Vol. 2)* (YASED, 2006) 3

⁶⁶ Protection of the Value of Turkish Currency Law No. 1567 (20 February 1930)

First of all, as the allocation of foreign currency was centralized, private sectors were faced with a situation in which the stability of the economy was contingent upon state intervention and the boundaries of the intervention were uncertain.⁶⁷ Activities of foreign investors were largely restricted and dependent on the decisions of government authorities. The inconvertibility of Turkish currency resulted in the stock exchange losing its exchange transactions and foreign capital accumulation role. The capital deficit of companies and discharge of the short-term external debt was met by a bank loan. This increased the dominance of banks in the financial sector.⁶⁸ This law is the basis of exchange controls in Turkey. When this piece of legislation is examined in detail, it is understood that its aim is to introduce flexible provisions that would enable the state to control the economy and economic regulations. For the success of foreign exchange policy and control, cooperation with the Central Bank of the state is compulsory. However, the inconsistency was that the Central Bank of Turkey was not established at the time the law came into force.⁶⁹ Therefore, the Council of Ministers was authorized to determine the extent of foreign currency and securities trading. However, the Council of Ministers did not have the required experience, ability and interest to the economy to determine the monetary policy. This shows the power of the state on the economy. The state extended the period of application of this law many times so as not to lose control of the economy and finally, in 1970, the law became a perpetual statute. Thus, as it can be seen until the 1980s, the Turkish economy was under the control of the state, and issues, such as legislation for foreign capital and investors, foreign capital incentives and managing foreign capital for the improvement

⁶⁷ See Chapter 2 Section 3.1 pg. 75 and Section 3.2 pg.78

⁶⁸ World Bank Group , 'Turkey Partnership: Country Program Snapshot' (October 2013) 4

⁶⁹ The Central Bank of the Republic of Turkey was established on 11 June 1930

of the state were ignored.⁷⁰ As a result, whenever demand for capital was likely to exceed the funds available, the Turkish economy could not benefit from foreign investment.

Until the 1980s, Turkey implemented a controlled exchange rate policy. In 1980, the government took liberalization decisions to stabilize the Turkish economy. In the context of these liberalization decisions, Turkey switched to a flexible exchange rate regime by reducing the value of the Turkish Lira against foreign currencies. These decisions produced a structural transformation in the Turkish economy and free market economic policies could start to be applied. After this economic liberalization, the government realized that it would need external resources. Initially, short-term foreign capital was the solution. Subsequently, an update of the laws regarding the economy, including the law of protection of the value of the Turkish currency, became essential.

The liberalization policy improved the investment environment. With Decision 32, the restrictions on foreign capital were removed and foreigners were allowed to buy and sell securities quoted on the Istanbul Stock Exchange.⁷¹ Article 15 of Decision 32 stated that securities and other capital market instruments could enter and exit the country freely. Capital market instruments offered by the legal entities established in Turkey could be sold in foreign states freely provided that the instruments were

⁷⁰ See Hüseyin Ağır, *Türkiye’de Finansal Liberalizasyon ve Finansal Gelişme İlişkisinin Ekonometrik Analizi (An Econometric Analyses of the Relation Between the Financial Liberalization and the Financial Development in Turkey)* (BDDK Kitapları, Yayın No. 8. 2010), Ali Eşiyok, ‘İktisadi Dönemler İtibari ile Türkiye Ekonomisinde Kalkınma (1923-2004)’ (Economic Development in Turkey as per Economic Cycles (1923-2004) Türkiye Kalkınma Bankası A.Ş, Ekonomik Araştırmalar, 2006, <[http://www.kalkinma.com.tr/data/file/raporlar/ESA/GA/2006-GA/GA-06-02-02_Turkiye_Ekonomisinde_Kalkinma_\(1924_2004\).pdf](http://www.kalkinma.com.tr/data/file/raporlar/ESA/GA/2006-GA/GA-06-02-02_Turkiye_Ekonomisinde_Kalkinma_(1924_2004).pdf)> accessed on 12 June 2015, 17-18, See also Sefer Sener, ‘Türkiye Ekonomisinde İkinci Dönem Liberal İktisat Politikaları’ (Second Period Liberal Economic Policies in the Turkish Economy) (2005) 3(1) Journal of Administration Sciences 141

⁷¹ The Republic of Turkey, Decision on the Protection of the value of Turkish Currency Decree No. 89/14391 (7 August 1989)

registered to the Capital Markets Board of Turkey. In addition, the issuance of foreign instruments to Turkey, public offerings and sales of these instruments were regulated under the provisions of the Capital Markets Law. It can be said that this Decision brought concrete provisions for the securities trade. It clearly proved that after the liberalization in the economy, the state could not continue to control the economy with a framework law. Decision 32 brought practical and clear provisions regarding foreign capital, made the investment environment liberal and enabled foreign investors to invest in the Turkish capital market. The state started to make new and more sophisticated rules regarding investment.

Nowadays, the Capital Markets Law regulates the operations of the capital market of Turkey. The Capital Markets Law does not differentiate between the operations of foreign investors and domestic investors. Foreign investors can benefit from all the rights that domestic investors have and they do not have to get permission from the Capital Markets Board of Turkey while they are trading through intermediaries.⁷²

5. Why Turkey needs external financing

The inflow of foreign capital offers a number of potential benefits to a host state. In many instances, developing states face the issue of saving gaps when financing their investments.⁷³ In addition, these states lack access to the necessary capital to produce their required goods and services, along with the labour and natural resources with which to supply them.⁷⁴ In the absence of well-developed capital markets, in which case domestic savings cannot be efficiently canalized into the market, foreign investments play a vital role because it contributes to filling the saving gaps by

⁷² See Decision No 95/6990 Foreign Investment Decision Framework Article 3 and No.2 Communiqué on Foreign Investment Decision Framework

⁷³ Imad A. Moosa, *Foreign Direct Investment Theory, Evidence and Practice* (Palgrave, 2002), 71

⁷⁴ Jesward W. Salacuse, *The Law of Investment Treaties* (OUP, 2009), 18

supplying foreign savings to finance investments. As a consequence of the foreign capital influx, savings available for use can be allocated to other uses.

In the same manner that foreign investment presents benefits to the host state, it also entails costs and risks. The cost of foreign investment to the host states' economy may be economic, political or social.⁷⁵ Therefore, it can be argued that the net impact of foreign investment is not always positive, and therefore foreign equity investments have certain disadvantages over other sources of foreign finance.

Firstly, an important distinction of equity investment concerns the goals pursued by investors, who are generally concerned with risk, and seek to maximize the return on their investment.⁷⁶ Such a decision is therefore motivated by the expected short-term high returns that are driven by the cyclical forces, like GDP growth rate, interest rate and market sentiment. Therefore, once the expected return of investment decreases due to a change in these factors, investors withdraw their investment, and place it in more promising instruments. Therefore, the liquidity of the stock market, which enables equity investors to sell their assets easily and quickly, is of vital importance to equity investors.⁷⁷ This structure of equity investment makes it the most volatile of all major types of foreign capital flows. States that base their economy on foreign equity investment can experience its damaging effects, either through an increased vulnerability to external shocks as a result of large equity capital inflows or massive outflows of capital in the event of a downturn in expectations, regarding returns as a

⁷⁵ Ibid, 19-21

⁷⁶ Laura Paez, *Liberalizing Financial Services and Foreign Direct Investment Developing a Framework for Commercial Banking FDI* (Palgrave Macmillan, 2011), 11

⁷⁷ UNCTAD, 'Comprehensive Study of the Interrelationship between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI)' (1999)

UNCTAD/GDS/DFSB/5, <http://unctad.org/en/Docs/pogdsdfsbd5.pdf> as accessed on 07 October 2015, 17

result of volatility. Both these situations have the potential to result in a broad economic recession, thus harming the host economy.

While it is undeniable that foreign equity investment improves a states' foreign exchange holding in the short-term, it can also have a detrimental effect on the host economy, should the cost of such finance exceed the benefit derived in the long run.⁷⁸

An example of such cost is the repatriation of profits. Although capital inflow takes place through foreign investment, it is also possible that capital outflow associated with foreign investment by way of repatriation of profits becomes of greater volume than the inflow.⁷⁹ The consequence of repatriation is that foreign investment exists for the benefit of the investor, but not always for the economy of the host state.

Taken together, there are a number of beneficial results of foreign investment to the economy of the host state. However, as discussed above, foreign investment does not always result in benefits to the host state. Thus, foreign capital inflows can be viewed as two sides of the same coin, with the potential to be both beneficial, and detrimental, to the host economy. Despite its negative effects, a state facing a current account deficit and a higher number of investment opportunities than it can afford to undertake, because of the low levels of domestic savings may find it beneficial to attract foreign investment capital.

Turkey is a rapidly growing emerging market. The Turkish economy has shown remarkable performance with an average annual real GDP growth rate of 5% between 2002 and 2012.⁸⁰ Despite the relatively high growth rate, Turkey's total external

⁷⁸ Salacuse (n. 74), 19

⁷⁹ John R. O'Neal and Frances H. O'Neal, 'Hegemony, Imperialism, and the Profitability of Foreign Investments' (1998) 42(2) *International Organisation* 347

⁸⁰ OECD, http://stats.oecd.org/index.aspx?DataSetCode=EO92_INTERNET accessed on 01 July 2015

financing requirement is around 25% of estimated GDP.⁸¹ Turkey is in need of external financing for two main reasons: low domestic savings rates and account deficit. Attracting external finance from foreign investors into Turkey has significant implications on meeting capital and saving deficits when there is capital shortfall.

Since the main source of investments is savings, Turkey cannot accumulate the required level of savings, because the lower national income per capita means that a lower percentage of the revenue is allocated to savings.⁸² This reveals the inadequacy of domestic savings. With low domestic savings of around 14% of GDP, Turkey's economic growth relies on capital inflows to finance its investments and growth. This means that the amount of funds that can be attracted from foreign investors will be an important determinant of the growth rate.

Additionally, domestic savings are not enough to satisfy domestic demand for capital.⁸³ As a result, a portion of investments are financed by borrowing from foreign sources. Therefore, the gap in the domestic savings rate is likely to widen the account deficit. There are accounts that provide financing for account deficit.⁸⁴ Account deficit can be financed by a tax boost, but this is difficult in states with lower income per capita. A heavy tax burden negatively affects the savings and investment decisions of both individuals and institutions. This would result in economic recession. Another

⁸¹ The World Bank, Turkey Regular Economic Brief, 2014

<http://www.worldbank.org/content/dam/Worldbank/document/eca/tr-reb-dec-2013-eng.pdf> accessed on 25 June 2015

⁸² Nedim Zillioğlu, *Gelişmekte Olan Ülkelerde Dış Borç Sorunu (The External Debt Problem in Developing States)* (Anadolu Üniversitesi Yayınları, 1984) 5

⁸³ Ercan Sancak and Nedret Demirci, 'Ulusal Tasarruflar Ve Türkiye'de Sürdürülebilir Büyüme İçin Tasarrufların Önemi' (National Savings and Importance of Savings for Sustainable Growth in Turkey) (2012) 8(2) *Ekonomik ve Sosyal Araştırmalar Dergisi* 159, 186, See also Melsa Ararat, Esra Süel, B. Burçin Yurtoğlu, 'Sustainable Investment in Turkey: The Case in Context - An Update' (2014) <<http://www.sseinitiative.org/wp-content/uploads/2014/05/Sustainable-Investment-in-Turkey-The-case-in-context-An-update.pdf>> accessed on 03 June 2015, 13

⁸⁴ See William H. Buiter, 'A Guide to Public Sector Debt and Deficits' (1985) *Economic Policy* 21 and Thomas J. Sargent and Neil Wallance, 'Some Unpleasant Monetarist Arithmetic' (1981) 5(3) *Federal Reserve Bank of Minneapolis Quarterly Review* 1

option for financing an account deficit is to use credit debt, which is paid back with interest. These options both increase inflation and the debt burden.⁸⁵ Therefore, account deficit is usually financed by foreign equity inflows because foreign capital provides debt-free sources of borrowing.⁸⁶ Because of the influx of foreign equity investment into Turkey, it became possible to invest more than the total amount of domestic savings. Thus, despite the lack of domestic savings and the account deficit, the economy has continued to grow. Consequently, attracting external finance from foreign sources into Turkey has had significant results on meeting capital, saving deficits and sustaining growth. For these reasons, the need for external financing in Turkey for economic development remains high.

Turkey has untapped investment potential, with least 5% growth rate per annum on average during the period 2002-2012.⁸⁷ However, as the expectation of investors is to maximize the rate of returns upon funds invested, other risks that may affect the investment returns become important as well as economic conditions. In investment, risk means risk of loss.⁸⁸ Over the last decades, concerns about risk in the financial markets also refer to the chance of loss of investment income if the dividend is reduced. Equity investors are more interested in returns on their investment than having control over the management of the invested company. As they may be geographically dispersed, it is assumed that they have less access to information than those inside the company. The difference between the levels of information would

⁸⁵ Güneri Akalın, ‘Anayasal İktisat ve Türkiye için Ekonomik Anayasa Önerisinin Değerlendirilmesi’ (Constitutional Economics and Assessment of the Constitutional Economics Proposal for Turkey) (1997) 185 *Vergi Dünyası* 23, 33

⁸⁶ The World Bank, Turkey Regular Economic Brief, 2013

<http://www.worldbank.org/content/dam/Worldbank/document/eca/tr-reb-eng-jul-2013.pdf> accessed on 25 July 2014

⁸⁷ The Republic of Turkey Ministry of Foreign Affairs, Economic outlook of Turkey < <http://www.mfa.gov.tr/prospects-and-recent-developments-in-the-turkish-economy.en.mfa> > accessed on 16 June 2015

⁸⁸ Harry Sauvain, *Investment Management* (3rd edn. Prentice-Hall International, 1967) 7

make no difference as long as insiders conveyed this information to the market and made decisions in the best interest of the company. However, asymmetric information between the managers and shareholders increases the possibility of reduction in the return of investment.⁸⁹ Investors may then become unwilling to hold equities of companies for which the expropriation is expected to be larger.⁹⁰ Thus, the possibility of investor expropriation by company insiders affects the price that investors are willing to pay for the equity, which in turn affects investment decisions.

Not surprisingly, economic growth alone would not be attractive for investors. The quality of the legal framework is relevant to investment decisions about whether or not to buy equities in certain companies. It has the capacity to provide a secure investment environment within which expropriation of investors can be limited and claims that comprise an investment can be exercised. It also enables investors to monitor and protect their own interests. In an investment environment where investor protection is low and law enforcement is less effective, expropriation may have negative consequences on investment decisions.

Foreign equity investment plays a critical role in saving deficits and sustaining growth in the Turkish economy. Turkey could possibly face a recession if there was a stop in capital inflows to the Turkish equity market. Policymakers can attract greater equity investments by improving the quality and enforcement of the legal framework offered to investors.⁹¹ In this context, corporate governance can be crucial in signalling the quality of the rights guaranteed to the investor and it can consequently be influential

⁸⁹ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, 'Investor Protection: Origins, Consequences, Reform' (1999) Financial Sector Discussion Paper No. 1, 1 <http://www1.worldbank.org/finance/assets/images/Fs01_web1.pdf> accessed on 25 June 2015

⁹⁰ Mariassunta Giannetti and Andrei Simonov, 'Which Investors Fear Expropriation? Evidence from Investors' Portfolio Choices' 61(3) The Journal Of Finance 1507, 1538, 1545

⁹¹ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Legal Determinants of External Finance' (1997) 52(3) The Journal of Finance 1131, 1151-1152

on the investors. Particular efforts are needed to improve the investment environment and transparency, and thus give a boost to investor confidence and raise Turkey's attractiveness to foreign portfolio investments as well as the states' external financing needs.

6. The role of corporate governance in foreign equity investment

The rate of return on invested capital and the risks associated with investment are two aspects investors usually consider before making any investment decision. Investors are concerned about the possibility of loss of investment income if the dividend is reduced.⁹² In unstable or unpredictable environments where trust and confidence are low, the risk of loss of investment income increases and capital flies away.⁹³ Transparent and accountable disclosure regimes can increase investor confidence while complex and concentrated ownership can create risk for investors because these can undermine transparency.

Research on corporate governance has documented that most firms around the world have concentrated ownership with insider control.⁹⁴ In companies with concentrated ownership structure, corporate governance is shaped by relationships between a group of controlling families and managers. Understanding these relationships and assessing whether these controlling shareholders have the ability to expropriate minority investors requires knowledge of politics, banking, family and social status connections among the business elites, all of which foreigners are less likely to have.⁹⁵ Insider control can be beneficial for minorities but it can also be a source of concern. The

⁹² Sauvain (n. 88) 7

⁹³ William Donaldson, Chairman of the U.S. Securities and Exchange Commission, 2005, <<http://www.sec.gov/news/speech/spch012505whd.htm>> accessed on 21 June 2015

⁹⁴ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, 'Corporate Ownership Around the World' (1999) 54(2) *Journal of Finance*, 471

⁹⁵ Christian Leuz, Karl V. Lins, Francis E. Warnock, 'Do Foreigners Invest Less in Poorly Governed Firms?' (2009) 22(8) *Review of Financial Studies* 3245, 3247

opaque nature of insider control can create information problems for foreign investors. The information asymmetries can influence the investment decisions of foreign investors. Low transparency and weak governance can cause foreign investors to either disinvest or not invest. Besides, understanding insider relationships is costly in states where companies disclose little information publicly. To attract more foreign capital, the fundamental issue for policy-makers should be to set and maintain standards that increase trust and confidence in the investment environment.

Companies may devise mechanisms to overcome the lack of trust and confidence in the existing investment environments. Corporate governance is one of these mechanisms that ensure investors to obtain adequate and accurate information about the companies.⁹⁶ Companies with good corporate governance operate with transparency, accountability, responsibility and fairness. Furthermore, it generates an environment of trust and confidence by balancing between the need of those having competing and conflicting interests whilst not in any way being detrimental to the interests of any of the shareholders in the company.

The effects of corporate governance on investment decisions remain relatively unexplored. Anecdotal evidence shows that the quality of corporate governance affects foreign investors' decisions about whether or not to buy stocks in certain companies.⁹⁷ However, in the absence of sufficient governance data, a systematic empirical investigation does not exist. Most prior studies are limited to a single dimension of corporate governance, such as the role of ownership structure and

⁹⁶ OECD (n. 9) Part V. Disclosure and Transparency

⁹⁷ McKinsey & Company, Global Investor Opinion Survey: Key Findings (2003) <http://www.eiod.org/uploads/Publications/Pdf/II-Rp-4-1.pdf>> accessed on 22 June 2015 and McKinsey & Company, McKinsey/KIOD Survey on Corporate Governance (2003) < http://www.eiod.org/uploads/publications/pdf/survey_mckinsey.pdf> accessed on 22 June 2015

insider control in foreign investment decisions, or taking foreign holdings from a number of states.

It was shown in one study that there is a close relationship between corporate governance and the portfolios held by foreign investors using the portfolio weights of US investors.⁹⁸ The results indicated that improvement of investor rights for the increase of the inflow of foreign equity investment is necessary across states where concentrated ownership exists. Other research explored the effects of corporate governance on investors' decisions to hold shares of the companies listed, for example, on the Swedish Stock Market. It was analysed whether foreign investors take the quality of corporate governance into account when selecting companies to invest in. These studies show that a weak corporate governance system affects the inflow of foreign equity investments.⁹⁹

Another study took a more direct approach by conducting a survey of 118 institutional investors from many states in order to get information about the preferences of these investors on corporate governance activities at both country-level and firm-level.¹⁰⁰ The results revealed that corporate governance is a determinant of investment decisions as the most important mechanism that mitigates agency conflicts between managers and shareholders where investor protection is weak. An important implication of this is that companies in states, where legal regimes are too weak to protect investors, may still be able to attract investors through stronger corporate governance mechanisms.

⁹⁸ Magnus Dahlquist, Lee Pinkowitz, René M. Stulz and Rohan Williamson, 'Corporate Governance and the Home Bias' (2003) 38(1) *The Journal of Financial and Quantitative Analysis* 87, 109

⁹⁹ Giannetti and Simonov (n. 90) 1538

¹⁰⁰ Joseph A. McCahery, Zacharias Sautner and Laura T. Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' Tilburg Law School Research Paper No. 010/2010, Tilburg at 21-22 and see Table V, 46

A more recent study used foreign shareholdings from 37 states to examine whether and how the corporate governance practices of firms affected the decisions of foreign investment.¹⁰¹ They found that foreign investors prefer to invest in firms which have strong corporate governance systems with good boards and independent auditors. The results of these studies show that investors tend to invest in companies that have better governance structures with better transparency and disclosure systems because these companies have more reliable and predictable investment environments and trust and confidence in them is high.

Research has shown that foreign investors face informational disadvantages.¹⁰² Foreign investors may find themselves less informed about a state and its companies. Thus, to avoid informational disadvantage, investors prefer to invest in companies which they are familiar with:¹⁰³ 'Familiarity is associated with a general sense of comfort with the known'.¹⁰⁴ To increase familiarity, information flows are crucial determinants of foreign investment. However, relevant and reliable information is generally not equally available to all market participants. Poor information about the markets and poor accounting standards constitute barriers to investment for foreign equity flows into emerging markets.¹⁰⁵ If foreign investors are less well-informed about a company, they invest less in that company. Given that investors behave this

¹⁰¹ Praveen Das, 'The Role of Corporate Governance in Foreign Investments' (2014) 24(3) *Applied Financial Economics* 188, 199-200

¹⁰² See Michael J. Brennan and H. Henry Cao, 'International Portfolio Investment Flows' (1997) 52 *The Journal of Finance* 1851 and Stijn Van Nieuwerburgh and Laura Veldkamp, 'Information Immobility and the Home Bias Puzzle' 64 *The Journal of Finance* 1187

¹⁰³ Robert C. Merton, 'A Simple Model of Capital Market Equilibrium with Incomplete Information' (1987) 42(3) *Journal of Finance* 483, 505-508

¹⁰⁴ Gur Huberman, 'Familiarity Breeds Investment' (2001) 14 (3) *The Review of Financial Studies* 659, 678

¹⁰⁵ Geert Bekaert, 'Market Integration and Investment Barriers in Emerging Equity Markets' (1995) 9(1) *World Bank Economic Review* 75, 77 and see also, Jun-Koo Kang and Rene M. Stulz, 'Why is There a Home Bias? An Analysis Of Foreign Portfolio Equity Ownership in Japan' (1997) 46(1) *Journal of Financial Economics* 3

way, it would be expected that foreign investors would invest more in states or stocks that they know better.

Markets with freely available reliable information are extreme cases. In the presence of informational disadvantage, foreign investors cannot determine the actual level of risk associated with the investment freely. The cost of acquiring information is a source of economic loss for investors. Thus, investors lower their information acquiring costs by investing in companies that adopt higher transparency standards. Transparency is the availability of specific reliable and relevant information about the company. It is one of the most important elements that enable an environment for foreign investment. At a macro level, transparency gives investors an idea about the level of stability of a states' economy.¹⁰⁶ If stability is absent in the economy, the investors' perception about the state is adversely affected. Investors may hesitate to invest in non-transparent states because poor transparency raises information costs for investors. At a micro level, transparency leads to a less costly flow of information, and facilitates accountability and predictability of outcomes. Under concentrated ownership with insider control, it is difficult to evaluate the true extent of expropriation of controlling insiders because the possibility of having asymmetric information between managers and shareholders increases. Insiders have incentive to engage in opportunistic behaviour.¹⁰⁷ As a result of corporate opacity, the monitoring costs of investors increase. Additionally, under concentrated insider control with greater information asymmetry, boards fulfil their monitoring function less

¹⁰⁶ OECD, 'Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs', 2002, Paris, <http://www.oecd.org/investment/investmentfordevelopment/1959815.pdf> accessed on 26 June 2014, 26

¹⁰⁷ Shleifer and Vishny (n. 5)758-759

effectively.¹⁰⁸ In that case, the verification costs of investors increase. Foreign investors can lower their monitoring costs by investing in companies with less information asymmetry, a better transparency policy and more effective boards. In a transparent company where investors had better information on the equity, the variance on investment returns would be lower because a company with good corporate governance mechanisms would ensure timely and reliable information as a consequence of better financial disclosure. Effective corporate governance increases transparency and, as a result, reduces perceived risks. This leads to an increase in returns on investment.

The overall evidence is consistent with the conjecture that information that is unreliable and costly to obtain persuades foreign investors to shy away from foreign stocks. This suggests that foreign investors having informational disadvantage in their foreign investments tilt the weight of their portfolio towards firms with better corporate governance to reduce their information costs and monitoring activities.

While communication between states may be near to instantaneous now, to acquire reliable information about foreign companies still requires considerable effort. On the one hand, the high cost of obtaining information about foreign companies is a major factor in investment decisions.¹⁰⁹ On the other hand, credibility of information disclosed to the public is essential to the investors. The crises are good reminders of the necessity for high quality financial disclosures and credible information about

¹⁰⁸ Charu G. Raheja, 'Determinants of Board Size and Composition: A Theory of Corporate Boards' (2005) 40 (2) *Journal of Financial and Quantitative Analysis* 283, 299

¹⁰⁹ See Reena Aggarwal, Leora Klapper, Peter D. Wysocki, 'Portfolio Preferences Of Foreign Institutional Investors' (2005) 29 *Journal of Banking and Finance* 2919, Brian J. Bushee and Christopher F. Noe, 'Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility' (2000) 38 *Journal of Accounting Research* 171

financial situations of companies.¹¹⁰ The wave of financial scandals, which have resulted from accounting fraud such as Enron, WorldCom and Tyco, has shaken investors' confidence internationally. In this respect, better accounting practices, audit qualities and disclosure practices play an important role in attracting foreign capital. Transparency and disclosure are fundamental components of the corporate governance debate which keep investors better informed about the way a company is being managed.

The accounting system is becoming increasingly important in obtaining credible information about the financial situation of companies. Survey results show that improved accounting disclosure is one of the most important policies affecting foreign investment in emerging markets. 71% of emerging market investors identified 'accounting disclosure' as 'very important' for their investment decisions.¹¹¹ In fact, foreign investors are more inclined to invest in companies with good corporate governance because these companies have better disclosure policies with high quality accounting information that allows foreign investors to reduce their risk and monitoring costs.

The accounting system ought to constitute a source of credible information and be based on an independent logic to protect all investors. However, the independence of disclosed information may decrease in companies where there are dominant shareholders.¹¹² Some of the most determined resistance to compliance with independent logic comes from controlling shareholders who have the incentive to

¹¹⁰ David M. Walker, 'Restoring Trust After Recent Accountability Failures' in Justin O'Brien, *Governing the Corporation : Regulation and Corporate Governance in an Age of Scandal and Global Markets* (Wiley Publishing, 2005) 21

¹¹¹ See McKinsey & Company, *Global Investor Opinion Survey: Key Findings* (2003) <http://www.eiod.org/uploads/Publications/Pdf/II-Rp-4-1.pdf> accessed on 2 June 2015

¹¹² John J. Forker, 'Corporate Governance and Disclosure Quality' (1992) 22(86) *Accounting and Business Research* 111, 117

make the financial reporting system increase their own interests rather than pursue a 'true and fair view' goal.¹¹³ Additionally, in states with weak disclosure regulation, foreign investors shy away the most from companies where insider control is high. One of the main reasons for this is information problems faced by foreign investors.¹¹⁴ Building on this notion, it would seem that information problems associated with poor disclosure prevent foreign investment. Regulators and governments aiming to sustainably increase foreign investments can take steps to prevent the opaque nature of insider control and create a convenient environment for foreign investment.

Increased accounting disclosure in a form that is more familiar to foreign investors is a way that companies can reduce foreign investors' information costs because information that is in a more familiar form is expected to reduce the information processing costs of investors. Companies can adopt International Accounting Standards (IAS) to provide increased accounting disclosure in a form that is more familiar to foreign investors. Compared with local standards, IAS generally leads to more credible information disclosure.¹¹⁵ With mandatory adoption by the European Union (EU) in 2005, IAS has become one of the most popular accounting models in the world. The adoption of this model has resulted in an increase in the comparability, reliability and transparency of companies because they are using an international language in accounting. It can be predicted that domestic investors are likely to have greater access to information about local companies, possess greater knowledge of the local economy and markets, and are likely to be more comfortable with local

¹¹³ Giovanni Melis and Andrea Melis, 'Financial Reporting, Corporate Governance and Parmalat: Was It a Financial Reporting Failure?' in Justin O'Brien, *Governing the Corporation : Regulation and Corporate Governance in an Age of Scandal and Global Markets* (Wiley Publishing, 2005) 238

¹¹⁴ Leuz, Lins, Warnock (n. 95) at 3249, Miguel A. Ferreira and Pedro P. Matos, 'The Colours of Investors' Money: Which Firms Attract Institutional Investors around the World?' (2008) 88(3) *Journal of Financial Economics* 499, 514

¹¹⁵ Hollis Ashbaugh and Morton Pincus, 'Domestic Accounting Standards, International Accounting Standards, and the Predictability of Earnings' (2001) 39 (3) *Journal of Accounting Research* 417, 423

accounting standard then foreign investors. Consistent with this concept, foreign investors tend to find the information provided by IAS to be incrementally useful. Based on this, it can be expected that the adoption of IAS will lead to an increase in foreign investment. This is consistent with the evidence that one economic consequence of the adoption of IAS is the enhanced ability to attract foreign investment because it provides more information in a more useful format and that in turn reduces the information costs of foreign investors.¹¹⁶

Foreign investment is one of the driving forces of economic growth. Corporate governance is essential for the proper functioning of this engine and governments make corporate governance reforms to improve transparency and accountability in the investment environment. However, if the policies are not properly implemented, business environments remain non-transparent. While a strong corporate governance regime facilitates foreign investment, the opposite is also true. The presence of foreign investors may promote better corporate governance and corporate accountability in companies in which they invest. Foreign investors can demand a transparent regime in which they can exercise their rights effectively and make informed use of their ownership functions in the companies that they are investing in. Therefore, improving the corporate governance framework can be a means of increasing foreign equity influx.

Conclusion

In an economic system, where capital can move freely and even electronically, states need to reinforce both institutional and legal infrastructures to protect the operation of

¹¹⁶ Vicentiu M. Covring, Mark L. Defond and Mingyi Hung, 'Home Bias, Foreign Mutual Fund Holdings, and the Voluntary Adoption of International Accounting Standards' (2007) 45(1) Journal of Accounting Research 41, 45

their stock markets against risks. This indicates the need for a tight relationship between the economy and the law.

It would be unlikely that foreign equity investment would take place in states where there was legal insufficiency. From this point of view, having a clearly defined legal framework for equity investment is pivotal. Foreign investment inflows are fundamental for states which suffer from gaps in their savings. A developed and well-functioning local capital market is a precondition for attracting foreign equity investors. Considering the history of the financial markets in Turkey, establishing a capital market was not an urgent need in the final years of the Ottoman Empire. Even though there were some attempts to negotiate financial securities, an organized stock market could not be established because of political and economic problems that had serious effects on other states as well as the Ottoman Empire, such as the world wars and the Great Depression. In the early years of the Turkish Republic, public debt far exceeded domestic savings. As a consequence, the capital market could not find enough resources for its development. Moreover, insufficient legal policies, such as foreign exchange controls and the removal of the convertibility of the Turkish currency, not only had a serious negative effect on the development of the capital market but also excluded foreign investors from the Turkish market. These policies transformed the Turkish economy into a closed economy.

There was no properly regulated stock exchange until 1986. The late establishment of the Turkish Stock Market led companies to use bank loans for external financing and the Turkish financial system to be dominated by the banks of which an important part was state-owned. The lack of competitiveness decelerated the development of the stock market and investment environment. The Turkish economy had been managed

by government application of planned development programs until the 1980s. After financial liberalization, Turkey considered foreign capital as a solution to its capital gap problem. Even though new regulations entered into force as a result of liberalization, there was still a concrete effect of the state on the economy. This created an insecure investment environment for foreign investors.

It can be argued that the economy under the control of the state could be influenced by political volatility. In such an investment environment, the state can be an agent that reflects the economic interests of its own constituencies. It can allocate power to economic figures, such as the state itself, company managers, owners, shareholders or stakeholders, by designing the legal rules and their enforcement accordingly. In the Turkish case, until the 1980s the government had the power to control the economy. This power shaped the ownership structure of the Turkish companies. This will be discussed in detail in the next chapter. For the time being, it suffices to say that the business community did not have trust to the ability of the state to maintain investor protection through laws and principles.

The Turkish market was not open to foreign competition, the capital market instruments that operated in foreign currency could not be traded. The role of foreign investment, therefore, remained limited. The volume and variety of foreign trade and capital flows to Turkey increased after 1990 as the controls on foreign exchange were removed by Decision 32. As a result, there was a greater increase in capital inflows especially in equity investments.¹¹⁷ This increase supports the assumption that liberalization in the economic policy improved the investment environment to encourage foreign investment.

¹¹⁷ The Central Bank of Turkish Republic, *Küreselleşmenin Türkiye Ekonomisine Etkileri (The Effects of Globalisation on Turkish Economy)* (Banknot Matbaası, 2002) 25-26

Domestic sources of external finance for companies are limited in Turkey because of individuals' investment preferences.¹¹⁸ Therefore, Turkey still deals with saving shortages and needs foreign capital investments to fund its growth and development. In response, foreign capital has become an increasingly important source of finance.

Acknowledging the huge impact that foreign investors may have on the Turkish stock market, this research on the relationship between foreign investors and corporate governance in Turkey is worth exploring. Previous studies have shown that corporate governance mechanisms of companies affect foreign investment decisions because improved corporate governance can serve to provide a more secure environment, and thereby encourage foreign investment. Corporate governance is embedded in the corporate culture.¹¹⁹ The previous Commercial Code of Turkey had deficiencies in the way effective corporate governance was pursued and a corporate culture was shaped. In the next chapters, the factors that influence the corporate culture in Turkey will be further investigated. Nevertheless, it is now evident that Turkey has been taking significant steps towards applying corporate governance principles in the last decade. Moreover, recent amendments in the TCC and revision of capital market legislation have aimed to improve corporate governance standards for all Turkish companies. Based on prior studies, it would seem that Turkish companies are likely to attract more foreign investors as a result of corporate governance regulations of the new TCC because effective corporate governance ensures a reliable, credible, accountable and transparent investment environment which decreases the investment risk of investors.

¹¹⁸ See Chapter 3 Section 1.1 pg. 95

¹¹⁹ See generally Lawrence Rosen, *Law as Culture An Invitation* (OUP, 2006)

Before examining the corporate governance principles and their legal structure in Turkey, the following chapter will demonstrate the separation of ownership and control and its relationship with agency problems.

Chapter 2

OWNERSHIP AND CONTROL OF THE PROPERTY

Introduction

In the late 19th century, the number and diversity of investors was significantly increased in joint-stock companies internationally.¹ As a result investors became dispersed and the dispersion of share ownership was so great that it was not possible anymore for individual shareholders to maintain control of their companies on their own. Delegation of control became necessary in order to conduct activities that would achieve the objectives of the company. This resulted in the separation of ownership and control. Shareholders delegated their decision control rights to professional managers. This engendered a separation in risk bearing and decision making functions.² When the owners are also the managers, they have strong incentive to take action in decision making because they are the residual claimants.³ However, when the agents run the company on behalf of the principal, they are not the residual claimant of the profit. They receive a small percentage of the return derived from their management decisions they make in on behalf of shareholders.⁴ When one party to the contract is expected to act in the other's best interests, there may be potential divergence between the interests of agents and principal. The principals expect to get the highest returns on their investments at a lowest possible risk.⁵ Consequently, they expect their agents to make decisions that maximise their interests and lower their

¹ Bob Tricker, 'The Evolution of Corporate Governance' in Thomas Clarke and Douglas Branson *The Sage Handbook of Corporate Governance* (Sage Publications, 2012), 55.

² Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' 26(2) *Journal of Law and Economics* 301, 304-305

³ Ibid

⁴ Brian R. Cheffins, 'The Determinants of Ownership and Control: Current Theories' in Brian R. Cheffins, *Corporate Ownership and Control: British Business Transformed* (Cambridge University Press 2008) 28

⁵ Tricker (n. 1) 55

risk. However, the agents are professional managers with an executive or supervisory function who are appointed to control and run the company in an efficient manner for a specific number of years. Their priority is to ensure that the long-term success and goals of the company are achieved and they make day-to-day decisions accordingly.

An agency problem is a risk-sharing problem, which arises when the parties to a contract have different attitudes toward risk and is common between principals and agents. The differences between the expectations of the principals and decisions of agents may result in conflict between the agents and the principals. This is also known as the agency theory.⁶ A balanced distribution of interests among the parties to the contract is crucial for the continuity of the company. Therefore, diversification of ownership and control among different interest groups is an important problem which incurs high costs to companies.

Generally, it is not possible for the parties to ensure that the agent will make decisions in the best interests of the principal at zero cost. Agency costs are the costs that must be incurred in order to reduce these conflicts. The harmful activities of the agent can be limited by means of the principals incurring monitoring costs, thus limiting divergences from their interests. In some cases, the agents can mitigate agency costs through bonding efforts to guarantee that the agent will take actions which do not harm the principal or to guarantee that the principal will be compensated if the agent takes such actions. Lastly, there may still remain some costs, despite adequate monitoring and bonding of management, and this is referred to as the residual loss.⁷

⁶ See Section 1.2 of this Chapter 2 pg.69

⁷ Michael C. Jensen and William H. Meckling 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3(4) Journal of Financial Economics 305, 310.

In their ground-breaking study, Berle and Means outlined the basis of agency theory.⁸ Agency theory is associated with companies in which ownership is separated from control. In these companies, different levels of risk perception and information asymmetry can be seen between principals and agents and these result in agency problems. Under information asymmetry, managers are better informed than potential investors about the company. However, as the separation of ownership and control is not seen in family companies, it is assumed that family controlled companies do not face agency problems.

This chapter aims to explain the emergence of corporate governance in family controlled companies in Turkey. In order to understand how corporate governance works, it is essential to start from the phenomenon of separation of ownership and control. Therefore, the first objective of this chapter is to define the concept of agency theory. A discussion will then follow on whether the assumption according to which states that the agency problem is reduced in family controlled companies still applies. The two major aspects of separation of ownership and control are managerial control, where there is no investor large enough to control the company, and shareholder control, where a group of large investors, generally families, control the company's management. Conventional wisdom suggests that, regardless between which parties the agency problem is, the ownership relation brings to light the external financing problem and hence corporate governance. The discussion will focus on family controlled companies because this is the ownership structure of most Turkish companies. These family controlled companies can issue shares to the public but the family keeps the control. This makes the agency problem the main issue of corporate

⁸ See Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publisher, 2007)

governance in Turkey since there is still a controlling group of shareholders, generally families.

The chapter starts with a brief historical overview of the separation of ownership and control in family businesses, which resulted in the emergence of salaried managers.⁹ As a consequence of the separation of ownership and control, who owns, who controls and for whom the companies should be governed became the main questions in relation to managing modern corporations. The chapter continues by explaining the agency theory. In this part, the notions of agency problem and agency costs will be defined, before the focus shifts towards the agency problems that can be seen in family controlled companies. Finally, the last part attempts to trace the ownership structure of Turkish companies and explain how families became dominant.

1. The emergence of the modern company

In order to examine the ownership status of property, Berle divided it into two categories: consumption property and productive property.¹⁰ This Thesis does not deal with the emergence and the effects of consumption property, which provides their owners a consumer service, such as a house or a wardrobe.¹¹ It will confine itself to the economic, legal and social effects of productive property from the aspect of management on the one hand and stock ownership on the other.

Production property is a property that is allocated to production, commerce, manufacture and service and as a consequence generates income. It is designed to offer a good, service or price to individuals from whom a holder anticipates to gain a

⁹ The terms 'director', 'manager' and 'management' are used interchangeably except where the context otherwise requires.

¹⁰ Adolf A. Berle, 'Property, Production and Revolution' (1965) 65(1) Colombia Law Review 1, 4-5

¹¹ Steven M. Cohn, *Reintroducing Macroeconomics: A Critical Approach* (M.E. Shape, 2007), 233

return.¹² Berle extended the classification by suggesting that the production property has two layers. The first one covers the active holders taking part in the companies' activities that expect a return through dividends, interests or profit distribution. The second layer is controlled by the representatives of passive owners, who do not wish to take part in the companies' activities.

The vast majority of companies around the world were incorporated as family businesses in which the individuals were also the controllers.¹³ It can be noted that these businesses still predominate in states with a short industrial history.¹⁴ Originally, a group of investors, generally family members, pooled and risked their earnings and efforts to carry on the business and become the owners by holding a legal title of an enterprise. The main characteristic of these companies was that the owners also controlled their corporations.

At the beginning of the 19th century, there were three ways to establish a business: to engage in business as a sole trader, in a partnership or as an unincorporated body.¹⁵ However, in each case the problem was that if the business became bankrupt, the owner was liable to the creditors until the owner became bankrupt.¹⁶ This was a disincentive for investors who wished to provide finance but not directly take part in managerial activities.

¹² Berle, (n. 10), 4.

¹³ Randall K. Morck (ed.), *A History of Corporate Governance Around the World: The World Family Business Groups To Professional Managers* (University of Chicago Press, 2005), 8.

¹⁴ Ibid

¹⁵ Bob Tricker, *Corporate Governance Principles, Policies and Practices* (Oxford University Press, 2011), 8

¹⁶ Tricker, (n. 1), 41.

At the turn of the 19th century, large-scale projects, such as transportation and communication technology, started to be financed by individual wealth.¹⁷ The building and operation of these projects were complex and required massive investment. During the same period, the developments in production technologies of the Industrial Revolution¹⁸ turned factories into the main form of production, and this separated control from the owners and workers.¹⁹ Large numbers of workers were brought under a management, and numerous individuals placed their savings under the same control. As the number of investors increased and became geographically dispersed, it became impossible for every owner to be physically involved in the process of managing and controlling the company for their own interests. This brought about the separation of ownership from management. Companies started to be operated by professional salaried managers. The owners were investors who had neither experience nor information nor the time to make decisions for the company. As a result, a new and enlarged type of entity was created. Consequently, the concept of the corporation changed.

A logical extension of the separation of ownership from control was that groups of shareholders engaged in a common activity attempted to simplify their activity by gaining legal personality for their enterprise. A consequence of the creation of a separate legal personality was the limited liability company, which is a type of corporation that limits the liability of shareholders for company debts. Limited liability is the incorporation of a legal entity which has many of the legal rights of a

¹⁷ Alfred D. Chandler and Takashi Hikino, *Scale and Scope: The Dynamics of Industrial Capitalism* (Harvard University Press, 2004), 1. See also Brian R. Cheffins, 'The Separation of Ownership and Control by 1914' in Cheffins (n. 4) Chapter 7, 221

¹⁸ The Industrial Revolution, which initiated in the UK and then subsequently spreaded across Europe, North America and eventually the world, is a period from the 18th to the 19th century, where major changes in agriculture, manufacturing, mining, transport, and technology had a profound effect on the cultural and socioeconomic conditions.

¹⁹ Gardiner C. Means, 'The Separation of Ownership and Control in American Industry' (1931) 46(1) *The Quarterly Journal of Economics* 68, 97.

real person, such as the right to sue and to be sued, to contract and to employ.²⁰ Beyond the life of its founders, the company has its own life because the shares of the founders can be transferred to other investors. This brought a shift in the idea of corporate property, which is used in connection with legal ownership.²¹ The company started to be understood as legal person with its physical plants, personnel and facilities necessary to produce, and which was dedicated to production instead of the personal consumption of individuals. Instead of investors' capital, the corporation charged a price for its outputs, paid taxes and all other expenses on this price. As a result, corporations gained legal personality.

The reason behind the creation of limited liability was the ability to raise capital from the public. Even if family companies were not in need of external sources of capital, wealthy families, which owned the companies, realised that becoming incorporated would limit their liability and protect them from the company's debts. This encouraged them to demand for external financing. Consequently, family owned companies started to receive external financing from new investors in exchange for ownership of their companies through the sale of shares to these new investors. Until the emergence of the above-mentioned developments and the need for additional sources of finance, the combination of ownership and management was the dominant pattern in the area of corporate management. After the increase in the number of limited liability companies, a more complex business model, limited liability,

²⁰ John Lowry and Alan Dignam, *Company Law* (7th edn. Elsevier, 2011), 77-82. See also David Kershaw, *Company Law in Context Text and Materials* (2nd edn., Oxford University Press 2012) Chapter 1, 3-30 and Paul L. Davies and Sarah Worthington, *Gower and Davies' Principles of Modern Company Law* (9th edn. Sweet and Maxwell, 2012) 39-42

²¹ Berle (n. 10), 7.

emerged. At the same time, many states removed inflow and outflow barriers to their capital markets which resulted in international investment.²²

Changes in the understanding of property and the size of corporations affected the concept of property ownership rights and the most notable change was that the personality of the individual owner was separate from the manager.²³ The corporation itself owned the legal title of intangible ‘things’.²⁴ The property owner acts in the expectation of gaining profit after the company pays taxes or, in case of liquidation, to get back part of his assets. As the number of investors increased, claiming their rights and expressing their opinions became difficult. Therefore, investors were given a right to vote to appoint managers and have a voice in important decisions regarding the company.

In addition, the Industrial Revolution encouraged industrial capitalism, and this provoked more liberal economic systems along with open participation in international trade.²⁵ Capitalism is an economic system of business organised around the private company and its production and allocation of capital. The basis of the capital is the savings of individuals. Different states use different ways to accumulate and allocate capital, and this is closely related to how each state handles corporate governance issues.²⁶ The different understanding of the meaning of capitalism shaped different states’ economies in different ways. For instance, in the US and the UK, capitalism is understood as a system in which a vast number of independent companies owned by millions of middle class shareowners compete with each other

²² Lowry and Dignam (n. 20), 402.

²³ Berle (n. 10), 12-13

²⁴ See Chapter 1 Section 2 pg. 26 for details of ‘thing’

²⁵ Michael C. Jensen, ‘The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems’ (1993) 48(3) *The Journal of Finance* 831, 835

²⁶ Morck (n. 13), 13-14.

for customers.²⁷ Individually, these shareholders are generally powerless. Only large outside investors can hold a large percentage of shares, and this gives them a voice in the management of the companies. On the other hand, in most of the rest of the world, capitalism created a system in which almost all corporations of the state are controlled by a handful of rich families. Family members, who wanted to safeguard their power in the companies hired professional managers to serve their interests.²⁸ It can be stated that separate management emerged, but was not accompanied by dispersed ownership. In these states, only a few corporations were truly independent. In terms of corporate governance, the focus in this Thesis will be on the separation of ownership and control.

1.1 Divergence of interest ownership and control

As ownership became more dispersed and investors more geographically spread, their links with the management of the companies became weaker.²⁹ In limited liability companies, the owners of corporations had the role of managing enterprises, assigning managers for gaining profits, while managers were to operate the corporations in the interests of the owners.³⁰ The problem that arises is whether those in control of the corporation would run it in the interests of its owners. In *The Wealth of Nations*, Adam Smith noted that the directors of joint-stock companies are the managers of other people's money, not of their own. It is expected that they will not watch over that money with the same anxious vigilance with which they watch over their own money.³¹ Since the managers are not the major residual claimants, they may take

²⁷ Lowry and Dignam (n. 20), 402.

²⁸ Ibid at 403

²⁹ Tricker (n. 15), 9.

³⁰ Means (n. 19), 69.

³¹ Adam Smith, *The Wealth of Nations* (University of Chicago Press, 2010) 264

actions that deviate from the interests of shareholders when effective control procedures do not exist.

Before the separation of ownership and control, the owner-worker had an interest in the entity, had power over it and acted with respect to it. However, after the separation, the owners fulfilled the first two functions only, while the third one was left to the professional managers. As a consequence, the group with interests in the enterprise began the 'owner' regardless of whether that group had power over it. The separation of ownership from control changed the legal concept of property from the perspective of corporations. Formerly, the concept of 'property' included the right to own, use, manage and control.³² After the separation, this bundle was divided into parts. Consequently, investors kept the right to receive residual rights and have a limited right to control, but the right to use, control and manage was given to the managers.³³

Berle and Means demonstrated that whenever there is separation between the shareholders and managers, agency problems arise. The governing body, which should protect the interests of the members, may instead abuse them. The relationship between shareholders and directors is perceived as an agency problem. It is argued that there is a possibility that agents seek to maximise their own benefits by taking actions that are advantageous to themselves but detrimental to investors.³⁴ Understanding the agency problem and reducing conflicts between shareholders and managers is important for the continuity and development of the companies.

³² Margaret M. Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century' (1995) in Thomas Clarke (ed.) *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (Routledge, 2004), 181.

³³ See Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Brookings Institution, 1995), 20 for a discussion on residual rights.

³⁴ Tricker (n. 15), 219.

1.2 Agency problem

The agency problem is a risk-sharing problem that arises when the parties to a contract have different attitudes toward risk. An agency relationship is a contract under which the managers (the agent) are engaged to fulfil some service on behalf of the owners (the principal) which includes delegating some decision-making authority to the agent.³⁵ The agents' aim is to run the company successfully in the long-term. On the other hand, the aim of principals is to gain maximum profit. Consequently, the agents may take a different attitude towards risk than the principals. The actions taken by the agents can be beneficial for their goals but detrimental to the shareholders.

The main difficulty is that, since the principal has less information than the agent, in other words there is information asymmetry, the principal cannot be sure whether the agent is performing as promised. In this case, the principals must trust to the agents' decisions and rely on the information provided to them. If the agents' decisions are detrimental to investors, this creates conflicts of interest within the corporation. It is difficult for the principal to verify whether the agent is actually acting in his best interests. Even though the principal can make some attempts 'the agency problems may be reduced, but not eliminated'.³⁶

The next part will focus on the conflict of interests between managers and investors in family corporations where there are controlling shareholders who possess the majority of shares and voting right. This is the case in most Turkish companies because the most common ownership structure is that of a family business. In such situations, agency problem arise when the manager acts on behalf of a group of investors but not for all investors.

³⁵ Jensen and Meckling (n. 7), 308.

³⁶ Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 Economic Journal 678, 681-686.

2. Agency problems in family-owned companies

A family business is a company, which is partly owned by one or a group of families who together control at least 20% of the total shares.³⁷ Family controlled businesses can be differentiated from non-family businesses by their ownership structure. The controlling shareholder, who is also the main decision-maker, is the family. The key objective of family companies is to create wealth across generations. The family members expect managers to govern the company with this objective in mind.

Family-owned companies comprise 95% of all Turkish companies and 75% of listed companies on Borsa Istanbul.³⁸ This does not mean that non-family companies do not play important role in the Turkish economy. However, the economic importance of these family held companies for Turkey's economy far outweighs the importance of widely held companies. While it is accepted that corporate governance problems in widely held companies are serious, the emphasis of this part will be on the agency problems that arise in family controlled companies. The poor legal protection for minority investors exacerbates the corporate governance problems in Turkish companies.

Three reasons can be inferred from the model of Jensen, Meckling and Fama that justify why family-managed companies do not deal with significant agency problems. Firstly, in widely dispersed companies, it is difficult to align the interests of investors and managers. However, in family owned companies, the dominant shareholder is the family and the members of the family are actively taking part in the management. Therefore, it is much easier to align the interests of shareholders and the amount of

³⁷ Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Ownership around the World' (1999) 54(2) The Journal of Finance 471, 477.

³⁸ Sinem Çalışkan, 'Overview of Family Business Relevant Issues Country Fiche Turkey' Project conducted on behalf of European Commission Enterprise and Industry Directorate-General <http://ec.europa.eu/enterprise/policies/sme/files/craft/family_business/doc/familybusiness_country_fiche_turkey_en.pdf> accessed on 26 June 2015

risk that shareholders would accept that the decisions of the management entails. This would naturally reduce agency costs in family owned companies.³⁹ The second reason is that the use of property rights is mostly restricted to internal decision-makers, who are family members. Therefore, their involvement in the management will ensure that the wealth of the shareholders will not be expropriated.⁴⁰ Lastly, since the shares are held by family members, the members have a close relationship with the decision-making agents and they have the opportunity to monitor the agents' decisions. This close relation between the principal and agent allows the agency problem to be controlled.

The conclusion from these three arguments is that family companies are controlled by owners-managers, which results in minimised, but not eliminated, agency costs and less costly governed corporations compared to widely held companies. In addition to Meckling and Fama's agency model, various studies have shown that agency costs are minimised in family controlled companies.⁴¹ Thus, concentrated ownership results in better corporate governance. Yet, these findings do not indicate that family controlled companies are always better governed than widely held ones. Since often the managers of the company and controlling owners are the same persons, it is more possible to protect investors' interest against managerial abuses.

³⁹ Eugene F. Fama and Michael C. Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 327, 332.

⁴⁰ *Ibid*

⁴¹ William S. Shulze, Michael H. Lubatkin and Richard N. Dino, 'Toward A Theory of Agency and Altruism in Family Firms' (2003) 18(4) *Journal of Business Venturing* 473-490; Ronald C. Anderson and David M. Reeb, 'Founding Family Ownership and Firm Performance' (2003) 58(3) *Journal of Finance* 1301-1328; Roberto Barontini and Lorenzo Caprio, 'The Effect of Family Control on Firm Value and Performance. Evidence from Continental Europe' (2005) ECGI Finance Working Paper 88/2005 and Loucas Spanos, Lena Tsipouri and Manolis Xanthakis, 'Corporate Governance Rating and Family Firms: The Greek Case' (2006) <<http://195.130.87.21:8080/dspace/bitstream/123456789/1160/1/Corporate%20governance%20rating%20and%20family%20firms%20the%20Greek%20case.pdf>> accessed on 26 June 2015

However, family control can give rise to its own set of agency problems.⁴² A set-off problem may arise when family controlled companies obtain equity financing. The family business group companies can use a pyramidal ownership structure to separate ownership from control. In pyramid ownership, families hold control blocks in several different publicly traded companies, each of which holds control blocks in more publicly traded companies and in turn, control more companies.⁴³ This ownership structure is used to provide capital to the company without losing the majority control of any company in the business group. In other words, companies obtain equity financing from investors but the family continue to hold the majority of votes.⁴⁴ In this case, the managers who have specific knowledge about the company may act for the benefits of family members, but not for the all shareholders. This case is even more serious in family controlled companies than in widely held ones, as it is not possible to oust a controlling family and allow the efficient transfer of control.

A result of pyramidal ownership structure is a divergence between the cash flow rights and the control rights of these families. In this case, the family is entrenched in all the companies of the group by their voting power and this results in the assignment of managers who act beneficially for the controlling shareholder. Since the interests of controlling family members and other shareholders are not aligned, there is the possibility that an agency problem arises because managers may act in the best interests of the family members and ignore the interests of minority investors. Thus, the agent is not held directly accountable to all investors. In addition, if the manager is a family member, the judgment about the appropriateness of manager's decisions can

⁴² Randall Morck and Bernard Yeung, 'Agency Problems in Large Family Business Groups' (2003) 27(4) *Entrepreneurship: Theory and Practice* 367, 369.

⁴³ Ibid 372

⁴⁴ Ibid

be biased because of emotions and family bonds.⁴⁵ These situations create less transparency and render monitoring ineffective.

In some cases, through bonding efforts, the investors can ensure that the agent takes actions which do not harm the principal. However, under limited rationality and information asymmetries, it may not be possible to designate performance criteria for the agent. In this case, the decision-makers, either a family member or a professional manager, can favour a certain group of shareholders' interests by using information not known to the other shareholders.⁴⁶

Financial scandals in diffused ownership companies usually differ from those companies with concentrated ownership.⁴⁷ In order to inflate stock prices and gain from their equity and options holdings, widely held company managers engage in earnings manipulation and accounting irregularities. In concentrated ownership, family entrenchment, through employing the pyramid structure of a family business group, enables the controlling family member shareholders to expropriate corporate resources especially if investor protection is poor.⁴⁸ When investors are not protected properly, controlling shareholders can be very protective of company specific information. Such secrecy can be very harmful for investors, as this increases information asymmetry. For instance, a family can extract benefits from the company it controls via non-transparent activities such as tunnelling. Tunnelling refers to the action of transferring an important part of the free cash flow by a controlling shareholder into a company in which they have large cash flow rights and control

⁴⁵ Luis R. Gomez-Mejia, Manuel Nuñez-Nickel and Isabel Gutierrez, 'The Role of Family Ties in Agency Contracts' (2001) 44(1) *Academy of Management Journal* 81, 84.

⁴⁶ Lutgart van Den Berghe and Steven Carchon, 'Agency Relations within the Family Business Systems: An Exploratory Approach' (2003) 11(3) *Corporate Governance* 171, 173.

⁴⁷ Luca Enriques and Paolo F. Volpin, 'Corporate Governance Reforms in Continental Europe' (2007) 21 *Journal of Economic Perspectives* 117, 125.

⁴⁸ Paolo F. Volpin, 'Governance with Poor Investor Protection: Evidence from Top Executive Turnover in Italy' 64(4) *Journal of Financial Economics* 61, 62

from a company in which they have small cash flow rights but large voting rights.⁴⁹ Tunnelling is a way for insiders to misappropriate minority investors' wealth. In a family business group, individual companies controlled by the same family obtain their goods/services and financial needs from each other. This may give an opportunity to controlling shareholders to artificially increase the prices of goods or services and transfer the profit from a company in which they have small cash flow rights to another in which they have large cash flow rights. Correspondingly, the group can transfer profit from the seller company to the buyer company through artificially low prices of goods and services. The advantage obtained by using corporate resources via tunnelling is likely to drive a wedge between the value of a company for the family member shareholders and the other investors. Therefore, the conflicts of interest between a controlling shareholder and other investors exhibits a particular corporate governance problem in relation to family owned companies which requires high quality monitoring and auditing of the controlling family.

A recent example of tunnelling is the *Parmalat* case in which the companies of a group were tunnelled out by the Tanzi family for at least a few billion US dollars and transferred to other companies that were directly owned by the family.⁵⁰ The lack of monitoring made the transfer of capital to other companies easier. Parmalat is a large financial scandal built on negligence, fraud, and corruption. In addition, it represents an extreme example of agency problems, coupled with expropriation of investors by a family that treated company resources as its own.

⁴⁹ Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Tunnelling' (2000) 90(2) *American Economic Review* 22, 22.

⁵⁰ Enriques and Volpin (n. 47), 123.

The outcome is that, contrary to Meckling and Fama's views, a family owned company structure is not an efficient way to reduce agency problems. When there is no separation of ownership and control, there are less agency problems. When the family members are controlling the company, generally the owner also happens to be the manager. Information asymmetry and different incentives are not an issue anymore. However, such ownership structure gives rise to agency problems when a manager who has superior information acts on behalf of a group of investors, the family and neglecting the others. Professional managers are hired by families. The lack of separation of ownership and control real terms in family companies may lead the professional managers to serve the family. The interests of family members become different to those of other investors. If the interests of these shareholders can be aligned, the agency problems can be reduced. However, as long as the managers act on behalf of the family, agency problems will continue to rise in family businesses.

In conclusion, it is seen that concentrated ownership does not eliminate agency problems. Therefore, it is a mistake to assume that owner management is a remedy for agency problems. Reducing agency problems is important for corporations wishing to attract more investment because agency problems limit the scope of the companies as it makes investors reluctant to entrust their wealth to others.

3. Ownership structure of Turkish companies

3.1 The state as the determining factor in the development of business activities

Governments shape their states' economy in several ways.⁵¹ This chapter concerns the ways in which governments shape the economy through interference in financial

⁵¹ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'The Quality of Government' (1999) 15(1) Journal of Law, Economics and Organization 222, 225. See also Marco Pagano and Paolo F. Volpin, 'The Political Economy of Finance' (2001) 17(4) Oxford Review of Economic Policy 502, 502-503.

markets. The main activity on which the Ottoman Empire based its economy was agriculture. There were not many companies operating in this period because of the economic conditions.⁵² Therefore, the ownership structure of Turkish companies was shaped after the proclamation of the Republic in 1923. It has been argued that the relative strength of the relationship between the state and business in the early period of industrialisation generated a very important factor, which shaped not only the role of the political authority as a guide for early entrepreneurs but also the future course of the relationship between these two actors.⁵³ Therefore, with all its concomitant economic results, it has become necessary to understand the legal effects of how the state-business relations shaped the financial market, ownership structure of companies and the related legislation in Turkey. Law results from a rather long political process.⁵⁴ Since state intervention made the ownership structure and regulatory frameworks develop in a particular way, examining state intervention throughout the Republican period (especially between 1923-1980s) provides an interesting opportunity to explain the corporate governance structure of Turkey.

A key characteristic of business activity in Turkey is that the state appears as the determining factor in the development of business life. The link between private sector actors and the state is direct and important. The Turkish state was heavily involved in the economy not only by regulating the economic environment and undertaking large projects but also as the major producer, employer, contractor, investor and the provider of necessary capital since the 1930s.⁵⁵ Being a mainly

⁵² See Chapter 1 Section 3 pg. 33

⁵³ Ayşe Buğra, *State and Business in Modern Turkey A Comparative Study* (State University of New York Press, 1994), 19.

⁵⁴ Marco Pagano and Paolo Volpin, 'The Political Economy of Corporate Governance' (2005) 95(4) *American Economic Review* 1005, 1005.

⁵⁵ Mehmet Uğur, *The European Union and Turkey: An Anchor/Credibility Dilemma* (Ashgate, 1999), 56.

agricultural economy with almost no capital accumulation and low growth rate, individuals did not have any incentive to invest. The underdevelopment of the capital market and financial organisations also obliged the state to provide capital to the economy. By reason of the private sector's inability to invest, the state had to undertake most of the investment.⁵⁶ The state set up a substructure by establishing a technological and trained labour base to lead the private sector. For this aim, the state economic enterprises were founded during the 1930s. State economic enterprises constituted the primary force for economic growth. Even though these enterprises were established to be managed independently of state authority, they were controlled by government civil servants.⁵⁷ The aim of establishing state economic enterprises was twofold: to close the investment gap due to the low level of private sector investment; and to encourage a few wealthy families to invest in areas of future growth which the state chose to leave to the private sector. The state aimed to structure the development of the private sector based on the large multi-activity companies established by these families. Accordingly, the state-business relations were mostly in relation to one particular group of capital owners: businessmen.⁵⁸ This relation increased the non-transparent links between the state and capital owners.

This strategic relation between the state and private sector led to various unintended outcomes. One of the most important outcomes was that entrepreneurs with political ties found it much easier to establish their businesses by quickly developing multi-activity holding companies. This resulted in a distinctive business form in Turkey:

⁵⁶ Ibid., 57.

⁵⁷ Mustafa A. Aysan, 'Culture and Corporate Governance: The Turkish Case' in Güler Aras and David Crowther (ed.) *Culture and Corporate Governance* (Social Responsibility Research Network, 2008), 132.

⁵⁸ Uğur (n. 55), 59.

business groups.⁵⁹ These business groups promoted cross-ownership, the controlling minority structure and privileged ownership structures in Turkey. Equally important, these links restricted the delegation of control to professional managements because solving problems became much easier when the owner was in direct contact with political authorities. In other words, state intervention restricted the allocation of power in the management of companies. Therefore, the owners remained as the managers and dominant shareholders of companies.

3.2 The reflection of state-business relations on business activity

The impact of the state on business structures could have been limited by the emergence of new forces in the political environment.⁶⁰ However, Turkey was a single-party regime until the 1950s. Since there was no opposition party, the government in power had the tendency to regard its political power as absolute, monopolising state power and fully controlling the legal system. As a result, the legal system became subordinate to the government-set economic strategy objectives. Frequent changes in policy orientation resulted in uncertainty and limited the role of law to maintaining a stable economic policy. Uncertainty in the business environment increased the lack of confidence.⁶¹ Given that the legal rules, which determined the nature of the relationship, were unclear and the legal basis of property rights was weak, entrepreneurs tried to avoid the risk which stemmed from the government-set economic strategies by trusting more in their personal relationships and maintaining family control instead of employing professional management in their companies.

⁵⁹ Business groups refer to the result of investments of a family or a group of families who established the core group of companies which are kept together for the aim of shifting resources when needed.

⁶⁰ Buğra (n. 53), 28.

⁶¹ Uğur, (n. 55), 59-60.

In the absence of an opposition party, foreign corporations could be a driving force to change the dynamics of the relationship between the state and business. However, since Turkey implemented a closed economic regime, foreign investment played a limited role in shaping the Turkish economy.⁶² Therefore, foreign capital and ownership did not emerge as a factor to affect the political context of business activity and limit state intervention. The comparative unimportance of foreign owned companies in the national economy has prevented the ties between the state and big corporations from being weakened. Such foreign control over corporations would have limited state intervention in business activities and weakened family dominance in business management. However, this has not been possible since the state was the main actor putting in place the dynamics of the relationship between Turkish businessmen and foreign investors.⁶³ The state's attitude towards foreign investment has been protectionist.⁶⁴ The complicated laws regulating these activities have increased the power of Turkish businessmen in comparison with their foreign business associates, who have not been able to operate alone in this complicated regulatory environment. As a consequence, foreign trade policy implemented during that period created a business environment in which entrepreneurial success largely depended on good connections in governmental circles. Since relations with foreigners were subject to extensive state control, each connection with foreign associates also involved an encounter with the state authority. The state had the tendency to disregard legal provisions for practical purposes.⁶⁵ In this sense, businessmen who had strong ties with the state had an advantage. The law for the protection of Turkish currency, detailed in chapter 1, exhibits a pivotal benchmark and clearly shows the duty the state

⁶² See Chapter 1 Section 4 pg. 37

⁶³ Buğra (n. 53), 67.

⁶⁴ See Chapter 1 Section 4 pg. 37

⁶⁵ Buğra (n. 53), 167.

imposed on itself to ensure the stability of the exchange rate. The activities of foreign investors were largely restricted by this law. The capital flow was brought under the control and limitation of the state. However, the measures the government used to fulfil this duty were not clearly stated.⁶⁶ On the one hand, foreign investors were heavily dependent on the discretion of government authorities yet, on the other, foreign investment played a role in increasing the state dependency of the business community instead of contributing to the Turkish economy. In this case, state intervention in the economy was a disincentive for foreign investors since it made both the investors and the company owners dependent on the state's discretion instead of providing them with property and investor protection rights.

A major political event at the beginning of the 1950s saw the introduction of a multi-party political system. The most important dimension of regulation, which had a crucial effect on the Turkish corporate governance structure in this period, was the foundation of the Turkish organised labour movement. Again, state intervention was a major factor that shaped the character of labour activities in the business structure.

The authoritarian structure of Turkish governments has also manifested itself in the balancing of the developmental needs of labour, both in the one party and multi-party era. As it can be seen in the Labour Code of 1936, the government preferred individual protection of labour by law instead of the recognition of collective rights. The rules on collective labour relations of the Act were quite restrictive and banned unions and any kind of strike action.⁶⁷ The government was reluctant though to

⁶⁶ See Protection of the Value of Turkish Currency Law No. 1567 (20 February 1930)

⁶⁷ See The Republic of Turkey, Labour Act Law No. 3008 (8 June 1936) Article 72

enforce the provisions of the Labour Code on private businesses.⁶⁸ Furthermore, the next legal reform of labour activities was more restrictive, as it declared illegal all associations based on community, religion, family or class interests.⁶⁹ In other words, unionisation was demolished *de facto* and *de jure*. This change holds a quite important position in Turkish labour history because it removed all the legal means by which workers could organise themselves. Facing problems in claiming their rights as individual protection, workers demanded legislation to guarantee their future implementation on the collective benefit of labour. This demand constituted the mainstay of unionisation activity in Turkey. The ban on forming class-based associations was lifted with the amendment of the Associations Act in 1947. Even though this amendment opened the way to organise trade unions again, it only lasted for a short time.⁷⁰

With the transition into a multi-party system, state-labour union relations took a slightly new turn. The political authority made an arrangement to define their limits clearly to control the labour unions. Finally, Turkey's first Trade Unions Act was accepted.⁷¹ This Act recognised the principles of union freedom and voluntary unionism. The Act was by no means trivial, as it highlighted the state-dependent characteristic of business. The rationale of the state was to keep the labour unions collaborating with the state. Although the labour union right was accepted, workers

⁶⁸ Mustafa G. Doğan, 'When Neoliberalism Confronts the Moral Economy of Workers: The Final Spring of Turkish Labour Unions' (2010) 11 European Journal of Turkish Studies <<https://ejts.revues.org/4321>> accessed on 22 June 2015

⁶⁹ Başak Kuş and Işık Özel, 'United We Restrain, Divided We Rule: Neoliberal Reforms and Labor Unions in Turkey and Mexico' (2010) 11 European Journal of Turkish Studies <https://ejts.revues.org/4291> accessed on 24 June 2015

⁷⁰ In the transition towards a multi-party system process, two socialist parties were established. The establishment of numerous trade unions followed the foundation of these parties. However, the socialist parties connected unions flourished very rapidly and when their members went up to thousands within a few months, the martial law commanded the close of both the socialist parties and the trade unions in 1946. See Fuat Man, 'The Perception of the Relationship Between Trade Unions and Politics in Turkey: A Tracking on the Related Acts' (2013) 9(4) Mediterranean Journal of Social Sciences 212, 216-217.

⁷¹ The Republic of Turkey, Trade Union Act No.5018 (20 February 1947)

could not get powerful enough to affect to political agenda because of political instabilities that resulted in military interventions.

Concerning the role of the state in shaping the structure of private businesses, it can be argued that the most devastating experience was that the state was reluctant to recognise other associations, such as labour unions. Under these circumstances, the owners of companies found themselves in a situation in which they were the only agent of the interests of third parties, such as small business and labour. The state, by designing a rule based on their own political objectives, affected the balance between the owners and other company related parties, such as investors and workers, which resulted in an asymmetry of interest representation between controlling owners and other interest groups. Since the largest part of the industrial establishments were owned by the state, state economic enterprises set minimum standards of conduct for private businesses.

As mentioned earlier, the typical big business form in Turkey is the large multi-activity companies in company groups. These company groups generally include their own banks.⁷² Activities in the banking sector are especially important as a determinant of the corporate governance structure of Turkey. As the companies grew, their need for external finance was increasing. Given the underdeveloped capital market and the family ownership structure of companies, owning a bank in the company group has been regarded as an attractive strategy to access low interest rate loans. However, it is crucial not to overlook the direction of company-bank relations. Turkish companies do not have organisational forms that are closely connected with each other around a strong bank. In other words, the bank is not assigned to coordinate group activities but

⁷² Burçin Yurtoğlu, 'Firm-Level Liquidity, Profitability and Investment' in Sumru Altuğ and Alpay Filiztekin (eds.), *The Turkish Economy: The Real Economy, Corporate Governance and Reform* (Routledge, 2006), 189.

instead the main company manages the whole group including the bank.⁷³ Therefore, the banks cannot monitor the management based on superior insights into the company's operations. In addition, as banks and companies began to have strong ownership ties, companies did not need any alternative ways to raise capital. Thus, the need for a stock exchange did not emerge until the late 1980s. Even later, as the banks in company groups satisfied the capital needs of companies, the owners did not issue more than half of the company shares to the public in order not to lose their control power over the management. As a result, investors did not have a strong enough voice in public company managements to affect their decisions. This has affected the underlying logic of corporate governance in Turkish companies.

Even though the state has historically played a crucial role in the Turkish economy up until the 1980s, it has been suggested that such state intervention in business relations had the effect of destabilising the business environment.⁷⁴ Central to this understanding is the argument that the legal regulations and bureaucracy are often subject to the requirements of social and economic policy objectives set by the government in power mainly for their own political objectives. With the aim of minimising government intervention in the business environment and liberalising the Turkish economy, policies began to come into force at the beginning of the 1980s. These policies were based on export, the private sector and competition-oriented free market conditions, and aimed to create incentives for foreign capital to be implemented instead of import-substitutional. Despite the efforts to liberalise the

⁷³ Lokman Gunduz and Ekrem Tatoglu, 'A Comparison of the Financial Characteristics of Group Affiliated and Independent Firms in Turkey' (2003) 15(1) *European Business Review* 48, 48.

⁷⁴ Metin Heper, 'The State and Interest Groups with Special Reference to Turkey' in Metin Heper (ed.) *Strong State and Economic Interest Groups: The Post-1980 Turkish Experience* (De Gruyter, 1991).

market, the state still has a regulatory role among market actors.⁷⁵ The policies, which were implemented, have not been adequate and rarely present a coherent perspective for the stability and liberalisation objectives of the government. Haphazard policy changes often seen in legal regulations were a reflection of changes in bureaucratic rules. As a result, stability in the economic environment has not been achieved.

The stock exchange was established in 1986. Public offerings started gradually, and the dividends paid by these publicly held companies were far less than the inflation rate of that period.⁷⁶ The higher level inflation rates led to higher interest rates. Consequently, people who had savings preferred to use their capital in investments that brought interest as a return. Therefore, it can be said that the interest of the public could not be directed to investment through the capital market.

3.3 Ownership and management structure of Turkish companies

Turkey can be classified as an ‘insider system’⁷⁷ state.⁷⁸ The companies are mostly owned by families and the states’ richest families are the dominant insiders. Family members are often the chief executive officers (CEOs), members of the boards of directors (BOD) or top managers of the companies.⁷⁹ Dominant shareholders can easily control the managers and force them to focus on maximising their interests. The typical Turkish holding company comprises a complicated web of intercompany shareholdings. In Turkey, without prior consent of the controlling shareholder to sell

⁷⁵ İstemi Demirag and Mehmet Serter, ‘Ownership Patterns and Control in Turkish Listed Companies’ (2003) 11 Corporate Governance 40, 41.

⁷⁶ Latif Çakıcı, ‘Türkiye’nin Ekonomik Gelişiminin Süratlendirilmesi İçin Sermaye Piyasası ve Bankalardan Beklenen Fonksiyonlar’ (The Expected Functions of the Capital Markets and Banks to Speed Up the Economic Development of Turkey) (1983) Uluslararası Sermaye Piyasası ve Bankalar Semineri, İzmir, Tütüncüler Bankası A.Ş., 105.

⁷⁷ The insider system is characterized by (1) few listed companies, (2) a large number of substantial share stakes, and (3) large inter-corporate shareholdings.

⁷⁸ Dennis C. Mueller, ‘Corporate Governance and Economic Performance’ (2006) 20(5) International Review of Applied Economics 623, 628.

⁷⁹ See Burcin Yurtoglu, ‘Ownership Structure of Turkish Listed Firms’ (1998) ISE Finance Award Series 55, available at < <http://www.imkb.gov.tr/Publications/isefinanceawardseries.aspx>>. See also Demirag and Serter (n. 75), 40-51.

his/her share, it is almost impossible to acquire a company.⁸⁰ This situation makes investors unwilling to invest in such companies because they do not have any governance rights. Moreover, it is not only direct share owners who can control the company managers. Through informal relations entered into between shareholders through both voting agreements and indirect ownership, large shareholders have the ability to control a company.

There was no significant improvement in the capital market environment until the 1960s and later, and the introduced laws limited the activities in the capital market.⁸¹ Since the early 1980s, the macroeconomic conditions of the Turkish economy suggest a potential role for company groups. Later, the capital needs of these companies increased. Thus, the development of the capital market accelerated. However, as a way of maintaining their controlling power in the companies, the controlling shareholders achieved the separation of ownership from control mostly through pyramidal or complex ownership structures. Generally, direct shareholders are not the true owners of Turkish traded companies. A shareholder with a higher ownership in the pyramid or through a complex organisation structure controls the company. The remaining shareholders have limited opportunities to influence the management and strategy of Turkish companies. An effective corporate control activity does not exist.

Economic stability and sustainable growth is important for an effective financial system. The markets are important elements for the effectiveness of liberal financial systems based on free-market economy. In the Turkish financial system, banking maintains its dominant position but the role of the capital market remains limited. In

⁸⁰ Burçin Yurtoğlu, 'Ownership, Control and Performance of Turkish Listed Firms' (2000) 27(2) *Empirica* 193, 195.

⁸¹ See Chapter 1 Section 3 pg. 33 and Section 4 pg. 37 for details

2012, the contribution of Borsa Istanbul in the economy was 23.6% of total GDP.⁸² Among the top 500 largest industrial companies of Turkey only 105 companies were publicly traded in the stock exchange, while among the second top 500 largest industrial companies, this was only the case for 140 companies. In total, 404 companies were listed in the Borsa Istanbul in 2012.⁸³ In recent years, activities, such as incentives for initial public offerings, improvements in the capital market investment environment and a comparatively more stable economy have increased the interests of both companies and investors in the capital markets. As a result, a significant increase has been seen in publicly traded companies.⁸⁴ This increase shows that an emphasis should be put on corporate governance applications in Turkey. In order to modernise and update business practices in Turkey, the reform of Turkey's commercial law, which was also a significant improvement for capital markets, took place in 2012. One of the most important reforms that have been made in the field of corporate law is that for the first time corporate governance is included in Turkish law. A detailed discussion of the new Commercial Code will be provided in the next chapter.

Conclusion

Across the world, family and closely held capitalism with the protection of ownership rights is the earliest type of corporate form. This is because in the early stages of economic development, when legal and regulatory institutions were not well developed, reliability in business was highly-valued. Blood kin in corporations could

⁸² İstanbul Üniversitesi Sermaye Piyasaları Araştırma Ve Uygulama Merkez (SERPAM), Araştırma Raporları, Türkiye Sermaye Piyasası 2012 Yılı Raporu, (Turkish Capital Markets, 2012 Annual Report) Subat 2013, 12 http://serpam.istanbul.edu.tr/wp-content/uploads/2013/02/SPR_2012.pdf accessed 25 June 2015

⁸³ Ibid., 18.

⁸⁴ Ibid., see Graph 2.3., 18

be considered more reliable than non-kin and so establishing family corporations was considered a safer option for the owners of the companies. However, the changing conditions of the economy forced family-owned companies to go public.

Regarding its impact on the economy, publicly held companies, which led to managerial capitalism, were a miraculous invention. Based on a complex set of contracting relationships that reflects the rights of the parties involved, the bulk of individual investors have committed their personal wealth to the hands of managers-agents.

This corporate form is not only useful for investors by generating profits out of having ownership in business, but also helps the economy by allowing companies that are in need of capital to obtain it with lower risk, thus enabling them to expand. Putting its advantages to one side, the separation of ownership and control continues to be a problem for listed companies with both concentrated and dispersed structures.

As a consequence of the corporate revolution, a new approach regarding the management of companies became necessary. From this the question of who owns the company has emerged. The profit generated belongs to the company. However, the term 'owner' of the company has been used for the group with interests in the company regardless of whether that group has power over it. However, one of the results of dispersed ownership is that it is not possible for all shareholders to manage and control the company. The shareholders hold rights over the stocks but have little controlling power over the company. It is in fact the managers who are running the company.

Agency theory aims to highlight how the related parties, principal and agents, should behave in order to manage the company better. However, as far as its practical application is concerned, there can be some challenges. The basic challenge is how to ensure the agents act solely in the interest of the principals. Moreover, the increase of joint-stock companies also increased the number of principals and agents. This made it more difficult to reflect the behaviours of parties now than it was in the 18th or 19th century. In addition, the interests of diversified shareholders are not homogeneous. Family companies are still common in Turkey. Obtaining sources of external finance brought non-family owners to family companies and ownership started to become dispersed. The controlling shareholders did not want to lose their controlling power and so formed pyramid structures to allow the family to achieve control of the company using only a small cash flow stake. By means of pyramidal structures, family members have either been able to manage the group of companies or control the managers of the companies. Nevertheless, the separation of ownership and control has not actually been achieved. Since the interests of family member shareholders are different than those of non-family shareholders, another challenge is present in family owned businesses. Agency problems continue to rise in family businesses.

The above problems show that the focus has always been on agency issues. However, limiting the focus to dispersed ownership is too narrow. Contrary to the assumption in agency theory, family-owned and managed companies can also give rise to agency problems. The problem of Berle and Means' agency theory is that it underestimated the number and importance of concentrated ownership companies around the world. In widely held companies, the concern is that professional managers may act for the benefit of the growth and continuity goals of the company but to the detriment of investors. Similarly, in family owned companies, managers may act for the controlling

family, but not for the shareholders in general. The conflict of interests between and within family members, managers and other shareholders increases agency problems. Thus, it is obvious that concentrated ownership does not replace the costly control mechanisms that publicly held companies use to reduce their agency costs. Therefore, there is a good reason for concentrated ownership companies to become the focus of the corporate governance debate because concentrated ownership of families raises the need for monitoring, transparency, accountability and fairness.

The shareholders' demand for reporting, accountability and transparency in company law, stock exchange rules and corporate governance principles are seen as a response to agency problems. In the last two decades, corporate governance has emerged as a means to mitigate the harmful effects of asymmetric information, monitor managers, align the interests of managers and owners, and prompt investors to make efficient investment decisions. Corporate governance encompasses all types of rules, regulations, codes and practices that permit companies to generate economic value for all their shareholders in the long-term, attract external financial and human capital, and work efficiently whilst respecting the values of the society to which it belongs to. Investors should gain trust to a company before buying its shares. They should invest in companies, which will be run both honestly and cleverly so that they can be sustainable and profitable. In states, where widely dispersed ownership is seen, the system entrusts professional managers with the governance of companies and investors with the monitoring of the quality of governance. However, in states, where family owned companies constitute a large percentage of the companies in the market, conservative families wishing to protect their status in the company can undermine the quality of governance. This is where corporate governance becomes critical. Corporate governance encourages ownership structures that minimise private benefits

of control. However, the shareholder power of corporate governance is confined by the controlling family because this power brings benefits to shareholders that families do not want to give up. This situation may prevent the creation of a trustworthy investment environment.

Most developing states, such as Turkey, borrow corporate governance structures from states, where the family business model of corporate ownership is absent. This results in the adoption and implementation of unsuitable corporate governance rules and principles in these emerging economies. Turkey's experience does not date back as far as other developed states because of political, economic and cultural reasons. In the early years of the Republic, the state played a dominant role in shaping the economy and strongly influenced the structure of the financial system. This encouraged capital owners to establish family-owned companies and holding companies. The state regarded big companies as a means to industrial development. The holding structure, which owns its own bank as well, enabled these companies to access bank credit easily. This led to two important outcomes. First, the banks, as creditors, did not have the role of monitoring the companies because they were also affiliated to the main company in which all the decisions were made by the dominant shareholders. Second, since the holding companies satisfied their external finance needs from their own banks, the establishment and development of the stock market was delayed. Insecure investment environment with insufficient laws and enforcement prevented companies from going public. Even if they satisfy their financing needs from external sources, less than half of the company shares were issued, because the controlling shareholders did not want to lower their cash flow and lose control over their management. Even though some big companies issued more than half of their shares, the owners held the majority of shares by a pyramidal shareholding. As a result, non-family shareholders

lacked majority and therefore the means to put their opinions forward. Just as with the banks, the role of investors in monitoring the company decisions became limited. Strong relations with the state gave the owners the opportunity to lobby the politicians in their regulatory efforts. Currently, the size and power of these companies enable them to present their interests to the government without a unionised channel. However, labour force could not interact with the state through lobbying by unions because these activities had been made illegal. The means to affect the policy that were available to businessmen were not available to labour. Consequently, all the stakeholders became part of less cohesive groups, which made them insignificant in both the regulatory process of the state and management of companies. This suggests that, due to the inefficiency of banks and investors in addition to the limited unionisation of interest groups, the ownership structure of companies resulted in an owner-oriented model of corporate governance in Turkey.

To sum up, Turkey is one of the states which have a family business dominated insider system. Families keep the majority control and family-owned multi-activity company groups with concentrated ownership dominate in the Turkish corporate sector. Turkey's corporate governance framework consists of the Turkish Commercial Code, the Capital Market Law and the Corporate Governance Principles of the Capital Market Board. The Commercial Code has recently been updated and modernised and includes corporate governance principles that require compulsory implementation by all companies. The main concern is whether it is possible to interpret these amendments in the new Turkish Commercial Code as a sign of development in the area of corporate governance accompanied by better implementation and enforcement. Before an attempt is made to answer this question, the next chapter will review the corporate governance-related activities in Turkey.

Chapter 3

CORPORATE GOVERNANCE STRUCTURE AND LEGAL ARRANGEMENTS IN TURKEY

Introduction

Over the last two decades, the liberalization of economies has created international capital flows and financial markets that have become increasingly integrated. This has resulted in a large pool of capital ready for investment in the capital markets of other states. Since access to external finance is a pivotal factor for economic growth, better corporate governance principles may have a significant role so that states can realize their economic potential.

The corporate governance concept originated mainly in developed states and expanded to developing states.¹ Therefore, the core dimensions of corporate law in any given jurisdiction reveal a number of similarities. These relate to issues such as public disclosure and transparency, and the need for accountability of management. However, there are also ‘various institutional differences in how the law deploys formal accountability mechanisms in legitimating corporate managers’ continuing possessions and exercise of discretionary administrative power’.² As a concomitant to this argument, it is submitted that the varying cultural and socio-political aspects of the existing legal and regulatory framework will have a path-dependent influence over the general structure of the regulations. Differences in the effectiveness of capital market development and ownership concentration of the companies may create the

¹ Özer Ertuna and Bengi Ertuna, ‘Evolution of Corporate Governance and Potential Contribution of Developing Countries’ in Güler Aras and David Crowther (eds.) *Global Perspectives on Corporate Governance and CSR* (Gower Publishing, 2009), 163.

² Daniel Attenborough, ‘The Vacuous Concept of Shareholder Voting Rights’ (2013) 14(2) *European Business Organization Law Review* 147, 162.

differences in investor protection against expropriation by controlling shareholders or managers.³ This is where corporate governance becomes crucial in the context of investment. Corporate governance helps to determine whether or not to invest in a company in a certain state because it allows investors to have confidence in their investments since well-governed companies have more transparent, accountable and trustworthy management with reliable financial information and reports. In brief, corporate governance is a set of mechanisms through which investors protect themselves against expropriation by controlling shareholders.⁴

Presumably, the willingness of investors to buy equity increases depending on the extent of the terms that protect their rights. States with better legal environments would then attract more investment because a better legal environment protects the shareholders against expropriation. Therefore, both a macro and micro-level approach to corporate governance has emerged as a fruitful way to attract foreign investments to stock markets. This incentivises both states and companies to strengthen their legal framework and corporate governance codes.

Although financial markets have become increasingly integrated over the last two decades, this has not helped much in terms of attracting greater investment to Turkey. Foreign capital is important for Turkey, where the demand for capital is likely to exceed the funds available domestically.⁵ By the end of 2012 there were more than 1 million investors in Borsa Istanbul. Even though only around 7,500 of these investors were foreign investors, the market value of the stocks that foreign investors held was

³ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Legal Determinants of External Finance' (1997) 52(3) *The Journal of Finance* 1131, 1131.

⁴ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Investor Protection and Corporate Governance' (2000) 58(1) *Journal of Financial Economics* 3, 4.

⁵ For the external financing need of Turkey see Chapter 1 Section 5 pg. 41

62%.⁶ This means that to increase the contribution of Borsa Istanbul to the economy, extensive regulations should be introduced to attract foreign investors to Borsa Istanbul. Corporate governance practices are critical in terms of attracting foreign investors to Borsa Istanbul since the development of a stock market is strongly related to the quality of shareholder and property rights.⁷

The chapter aims to examine the reformed TCC to assess the deficiencies of the current Turkish legal system for the establishment of an effective corporate governance system. In order to highlight the potential strengths and weaknesses of the Capital Markets Board Corporate Governance Principles, the application of the OECD Corporate Governance Principles will be discussed under Turkish law. In transposing the OECD corporate governance framework into the Turkish corporate landscape, the pattern of corporate ownership and institutional norms, such as political, social and cultural, may affect the success of the implementing principles because the Turkish commercial legal landscape is inherently different to the UK and US systems in which corporate ownership structure is widespread.

The chapter intends to shed light on whether improvements in the new TCC contribute to providing more suitable corporate governance practices to the Turkish business environment and thus enable a more secure environment encouraging foreign capital flow to Turkey. The new TCC have managed to improve the level of corporate governance implementation for companies listed on Borsa Istanbul.

⁶Central Registry Agency, Exchange Trend Reports (2012), 9, <https://www.mkk.com.tr/project/MKK/file/content/Bilgi%20Merkezi%20Dosyalar%C4%B1%2FBorsa%20Trendleri%20Raporu%2FBorsa_Trendleri_Raporu_I> accessed on 25 June 2015

⁷ See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Law and Finance' (1998) 106 (6) Journal of Political Economy 1113-1155.

The remainder of the chapter proceeds as follows. It begins with a brief overview of the Turkish corporate sector and continues with sources of Turkish company law as well as a critical examination of the prevailing corporate ownership structure and dimensions of the corporate form, where relevant. In doing so, it highlights the significant role of the state in determining the key characteristics of the Turkish corporate governance framework. Second, the corporate accountability mechanisms which address the problem of securing the legitimacy and sustainability of corporate managers' discretionary administrative power within large economic organizations will be examined. It will emphasise the responses of the Capital Markets Board (CMB) and Borsa Istanbul. Thirdly, this chapter will outline and explain how the OECD Corporate Governance Principles have acted as a driver for recent change in Turkey. Finally, the role the state played in policy-making and enforcement of corporate governance will be discussed.

1. Corporate governance understanding in Turkey

1.1 Outlook of the Turkish financial and corporate sector

For a healthy financial system, there should be a balance between bank and non-bank financial institutions because in providing financial services they do not substitute but in fact complement each other.⁸ Better functioning financial systems lower the cost of external finance. Turkey's financial sector is still in the development stage, and the sector has always been dominated by the banks.⁹ This may be normal considering that every group of companies in Turkey hosts its own bank. Bank financing has advantages for companies, for instance, banks can reduce misuse of loans by

⁸ The World Bank, *A World Bank Country Study: Non-Bank Financial Institutions and Capital Markets in Turkey* (The World Bank, 2003), 5.

⁹ Canan Yıldırım, 'Competition in Turkish Banking: Impacts of Restructuring and the Global Financial Crisis' 52(2) *The Developing Economies* 95, 95, The Banks Association of Turkey, 'Financial Sector and Banking System in Turkey' (2005)

< <http://www.tbb.org.tr/english/tbbbrostur10032005englishi.pdf> > , 12 accessed on 26 June 2015

monitoring borrowers.¹⁰ However, bank financing also has a downside. Evidence shows that funds raised from banks are more costly for corporations since banks extract interest from their customers.¹¹ On the other hand, a number of firms are able to become public companies to secure financial resources for expansion, rather than relying on bank loans. ‘Going public’ generates fixed costs, and therefore imposes a burden on many smaller companies. However, the stock market can prove an alternative means of lowering the costs of borrowing for larger companies. Therefore, in order to secure a healthy economy, it is important to balance the functions of the different financial systems. Increasing role of securities market in the Turkish economy could be a way to accelerate the effectiveness of the financial system for economic growth.

Market capitalization of the stock exchange has fluctuated over the years in Turkey.¹² It can be debated that if the equity market had not been affected by the crowding-out effect of the government borrowing from the equity market during the past decades, the development of the equity market would have been much more advanced.¹³ After 1980, public debt was consistently on the increase in Turkey. The level of public debt escalated when the financial crisis occurred in 2001.¹⁴ As a result of its large debt, the government frequently paid for its high sovereign risk with a real interest rate on government debt securities ranging from between 20 and 40%. Consequently,

¹⁰ Douglas W. Diamond, ‘Financial Intermediation and Delegated Monitoring’ (1984) 51(3) *The Review of Economic Studies* 393, 410.

¹¹ David E. Weinstein and Yishay Yafeh, ‘On the Costs of a Bank-Centred Financial System: Evidence from the Changing Main Bank Relations in Japan’ (1998) 53(2) *The Journal of Finance* 635, 656.

¹² See Table- ISE Market Capitalization (US \$ Billion) in Istanbul Menkul Kıymetler Borsası, ‘Istanbul Stock Exchange by Figures’, 13, <<http://borsaistanbul.com/data/kilavuzlar/Verilerle%20C4%B0MKB%20ISE%20by%20Figures.pdf>> accessed 18 June 2015

¹³ Crowding out is an economic concept where increased public sector spending replaces private sector spending.

¹⁴ Association of Treasury Controllers, Public Finances, <<http://www.hazine.org.tr/en/index.php/turkish-economy/public-finances>> accessed 18 June 2015.

government debt securities were perceived as being less risky investment instruments than investing in equities during that period of the Turkish economy. In addition to this, such a high interest rate has attracted all types of investment resources to government debt securities. Subsequently, the equity market did not look particularly attractive. In that period, the crowding-out effect was not the only aspect that inhibited the development of the equity market. An environment of political uncertainty, chronically high inflation and continued macro-economic instability had directed a substantial share of savings into investment instruments other than equities, such as gold, housing and foreign currency.¹⁵ This can be attributed to the low level of trust in the equity market among citizens because of high inflation and the absence of financial deepening as well as the absence of well-defined shareholder rights. As a concomitant, the financial sector could not become any deeper and broader; in fact, it became vulnerable to crises, which led to a shortage of capital supply. This situation continued as long as these instruments provided a hedge against inflation. Turkey could not benefit from the advantages of the equity market until the late 1990s due to economic imbalances and dominance of the government debt market. The equity market has remained relatively small.¹⁶ Capital markets have the pivotal benefit of accumulated capital which is crucial for the continuity of firm activities. Given that demand for capital is likely to exceed the funds available in Turkey, it can be suggested that increasing capital accumulation by Borsa Istanbul's contribution to the Turkish economy is of vital importance.

The structure of large listed Turkish companies has already been portrayed in the previous chapter. The remaining comprises small and medium-sized enterprises

¹⁵ The World Bank (n. 8), 8-19.

¹⁶ Capital Markets Board of Turkey, 2011 Annual Report <http://www.cmb.gov.tr/displayfile.aspx?action=displayfile&pageid=85&fn=85.pdf> accessed on 21 June 2015

(SMEs¹⁷) which account for a major part of the economy.¹⁸ Political and economic instability prevented the private sector from thriving and created a corporate community dominated by SMEs, which are mostly managed by their owners. Improving corporate governance in Turkey seems to be a very difficult task exactly because the majority of the firms are SMEs. Smallness leads to dependence on the owner, management practices are authoritative and the owner makes the strategic decisions without any professional input or practice. Moreover, the company accounts are often mixed up with those of the owners.¹⁹ Corporate governance in SMEs is a point that needs to be considered in order to take further steps towards applying better corporate governance standards in the Turkish business culture. Nevertheless, most of the SMEs were completely unaware of the importance of corporate governance principles until the new TCC. This is one of the significant improvements of Turkish law.

Listing in the stock exchange usually entails high costs and requires additional processes that SMEs may struggle with. To encourage SMEs to improve their corporate standards and facilitate SME listing, the CMB established the Emerging Companies Market in 2011. Emerging Companies Market is a bridge for companies which do not satisfy the listing requirements of Borsa Istanbul national market,²⁰ specifically, to reach a level of capital accumulation, stock liquidity, adoption of corporate governance principles, awareness and credibility. Even though with the

¹⁷ The SMEs are defined as 'Enterprises employing less than 50 persons and whose annual sales revenue or the financial balance sheet not exceeding 8 million Turkish Liras is called small-sized enterprises' and 'Enterprises employing less than 250 employees and whose annual sales figures or the financial balance sheet not exceeding 25 million Turkish Liras is called medium-sized enterprises' Official Gazette Decision No: 2012/3834 (4 November 2012)

¹⁸ Turkish Statistical Institute, TÜİK Haber Bülteni NO:13146, (*Turkish Statistical Institute News Bulletin*) (19 October 2012) < <http://www.tuik.gov.tr/PreHaberBultenleri.do?id=13146> > accessed 19 June 2015

¹⁹ Mustafa Aysan, 'Culture and Corporate Governance: The Turkish Case' in Güler Aras and David Crowther, *Culture and Corporate Governance* (Social Responsibility Research Network, 2008) 139.

²⁰ National Market is the main market of Borsa İstanbul where the stocks of companies are traded.

current CMB rules, companies listed on the Emerging Companies Market are exempt from applying corporate governance principles, the provisions of the new TCC are paving the way for corporate governance principles to be applied in SMEs. It is almost certain that the new TCC would facilitate the implementation of corporate governance in a more extensive way among SMEs.

The development of capital markets is a fundamental factor in promoting economic growth and thereby increasing the funding level of the private sector in the economic activity in Turkey. In Turkey, domestically available funds are less than the demand for capital. However, the ability of Turkey to attract foreign equity has been limited. It appears that corporations have not benefited from foreign equity inflows due to a perception of lower corporate standards by foreign investors. The paucity of foreign capital has increased the importance of corporate governance.

It is self-evident that, in order to increase development in the equity market, there is a critical need to have an efficient legal, regulatory and incentive framework in place as a foundation. The implementation of corporate governance principles is closely related to, and affected by, the ownership and managerial structures of the prevailing corporate characteristics. The Turkish corporate structure points to the fact that the Turkish governance model derives from the OECD model of corporate governance.²¹ An important element of this model of corporate governance is missing in the case of Turkey, that is a widespread shareholding of companies in a developed capital market. Most of the Turkish companies are family-controlled. Even if these companies go public, the families continue to have control over the firms.²² Even though Turkish law shapes the framework of rules and principles to protect shareholder rights, due to

²¹ See Aylin Poroy Arsoy and David Crowther, 'Corporate Governance in Turkey: Reform and Convergence' (2008) 4(3) Social Responsibility Journal 407, 416-418

²² For the ownership structure of Turkish firms see Chapter 2 Section 3.3 pg. 84

the corporate culture and ownership structure, investors may face problems as companies do not always comply with these rules and principles. The previous TCC says that the main document that is the basis of shareholder rights is the Articles of Association. This means that, even if the regulatory framework is well documented, the enforcement may not always be of the required level. The low level of enforcement renders much of the protection afforded to non-controlling shareholders ineffective. When the implementation of investor protection does not work well, investors are unwilling to finance firms. One way to increase the enforcement of protection is to adopt a robust corporate governance framework that fits with the Turkish corporate culture. This would provide confidence to investors, incentives to invest in the market and an increase the percentage of Borsa Istanbul in the Turkish economy.

1.2 Overview of Turkish institutional framework

Turkey is a civil law state with a legal and institutional framework in place concerning the governance of companies. The primary source of Turkish company law is the TCC. This has been in force since 1850 and was amended in 1926, 1956 and 2012.²³ The TCC is a comprehensive code, which sets out the rules for the establishment and operation of companies in Turkey. The TCC also sets forth the framework of corporate governance in Turkey. However, since 1981 the Capital Market Law has governed the operation of securities markets.²⁴ The Capital Markets Law defines the kind of investment instruments that can be issued, sets out the public offering procedures as well as the initial and continuous disclosure requirements, while

²³ See The Republic of Turkey Turkish Commercial Code Law No. 6102 (31 January 2011), <<http://www.tbmm.gov.tr/kanunlar/k6102.html>> accessed on 25 June 2015

²⁴ Capital Markets Board of Turkey, Capital Market Law No. 2499 (30.07.1981) (obsolete), Capital Markets Board of Turkey, Capital Market Law No. 6362 (30 December 2012) <<http://www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=1&pid=1&submenuheader=-1>> accessed on 26 June 2015

supervises and monitors financial intermediaries and institutional investors operating in the market. The Capital Markets Law determines the limits of the regulatory powers of the CMB, which is the regulatory and supervisory authority responsible for the securities markets in Turkey. The CMB drafts bills, which are known as "communiqués", to be submitted to Parliament for approval and issues regulations. In broad terms, the Capital Markets Law authorises the CMB to regulate the capital markets, monitor compliance with the legislation, take necessary precautionary measures in order to prevent breaches and apply administrative sanctions in the case of a breach.

Throughout its history, Turkey has experienced many severe economic and political crises, one of which took place in 2001. The essential factors of this crisis were the inability of the financial sector to provide funds to prevent the crisis, an outflow of capital to other states and inadequate regulatory precautions against crises. The financial system virtually collapsed as did the economy, with the money, capital and stock markets becoming debilitated.²⁵ This atmosphere of chaos pushed both foreign and domestic investors to minimise their losses and save their money by exiting the market. This resulted in an institutional financial deficit. Turkey applied to the International Monetary Fund (IMF) for support. The IMF released the credit on one condition: Turkey was expected to introduce good corporate governance principles into both its public and private sectors.²⁶ The very first response came from the Turkish business community. The Turkish Industrialists and Businessmen's Association, OECD and the European Union jointly organized a meeting called "EU

²⁵ Poroy Arsoy and Crowther (n. 21), 409. See also Nevin Yörük, Cumhur Erdem and Meziyet Sema Erdem 'Testing for Linear and Nonlinear Granger Causality in the Stock Price – Volume Relation: Turkish Banking Firms' Evidence' (2006) 2(3) Applied Financial Economics Letters 165, 165.

²⁶ Dilek Temiz and Aytaç Gökmen, 'The 2000-2001 Financial Crisis in Turkey and the Global Economic Crisis Of 2008-2009: Reasons And Comparisons' (2009) 1(1) International Journal of Social Sciences and Humanity Studies 1, 3.

towards Good Governance" in 2001.²⁷ As a result, in 2003, the Corporate Governance Principles of the Capital Markets Board, which were construed in line with the OECD principles, were issued for publicly-held companies with the aim of aligning the capital markets' regulation of Turkey with the one of the global financial markets.

Turkey is in the process of meeting the criteria for becoming a member of the EU. For Turkey, harmonisation and fulfilment of the legal framework was a prerequisite for becoming a full member of the EU.²⁸ This has further supported the development of corporate governance standards and their incorporation in the Turkish legislation. In this context, a new capital markets law compatible with the EU legal infrastructure has been drafted. In the course of time, an important part of the Capital Markets Board Corporate Governance Principles has been added to the capital market legislation by the communiqués issued by the government. More importantly, corporate governance principles started to form part of the Capital Markets Law and new TCC in the last decade.

It is difficult to determine what Turkey's position is on corporate governance. Turkey's corporate culture is closer to the one of continental European countries. In addition, Turkey has made reforms to harmonise its regulatory framework with the EU rules in order to become a full member. Under these circumstances, one would expect that Turkey applies a European model of corporate governance. However, since the OECD principles were taken as an example, the Anglo-American model of corporate governance has been applied from the beginning. There is no consistency between Turkey's aim and its corporate culture and the applied principles. Along with

²⁷ NTV, 'TÜSİAD: Mutlaka Daha İyi Yönetim' (Turkish Industry & Business Association: Better Governance is Necessary) 19 September 2000, <<http://arsiv.ntvmsnbc.com/news/31295.asp>> accessed 15 June 2015.

²⁸ Republic of Turkey, Ministry of EU Affairs, Accession Negotiations in Accession Policy Directorate <<http://www.abgs.gov.tr/index.php?p=37&l=2>> accessed 24 June 2015.

this, there is no clear explanation for choosing the OECD principles in the first place. It appears that Turkey has chosen the OECD Corporate Governance Principles for two main reasons. Firstly, due to the IMF's condition for the provision of loan credit, the OECD Corporate Governance Principles were used in the private sector. Secondly, even though the development of corporate governance principles was prerequisite in the context of the EU harmonisation reforms, the structure and operation of the principles to be regulated was left to Turkey. The CMB started to incorporate the OECD principles in the company laws and regulations by stating that these were the current practices recognised by both Turkish companies and worldwide, instead of establishing a new framework of corporate governance that is more suitable for its corporate culture and that would make the implementation of corporate governance principles more widespread and smooth.²⁹ Thus, Turkey fulfils not only the condition for the provision of loan credit but also prerequisite for becoming a full member of the EU.

Capital is not widespread in Turkey because of the prevailing concentrated ownership structure. After the economic liberalization of the 1980s, Turkey's economy started to head towards a UK-US type of capitalism, which relies on competitive and free markets and where market activities are guided by a price mechanism. It was seen as a necessity for financial deepening, development of the stock exchange and expanding the investor base in Turkey for economic development by the CMB.³⁰ The Anglo-American corporate governance system has a widespread shareholding structure

²⁹ Capital Markets Board of Turkey, Corporate Governance Principles Capital Markets Board of Turkey (2003), 7 http://www.cmb.gov.tr/regulations/files/corporate_governance.pdf accessed on 25 June 2015

³⁰ Milliyet Gazetesi, 'Yatırımcı Tabanının Genişletilmesi Gerekli' (Broadening the Investor Base is a Necessity) 09 September 2008

< <http://www.milliyet.com.tr/default.aspx?aType=SonDakika&ArticleID=988829>> accessed 15 June 2014 and Milliyet Gazetesi, 'Borsa İstanbul Derinlik Kazanmalı' (Borsa Istanbul Should Gain Depth) 16 December 2013 < <http://ekonomi.milliyet.com.tr/borsa-istanbul-derinlik-kazanmalı/ekonomi/detay/1808525/default.htm>> accessed 15 June 2015

with sophisticated capital markets in which firm activities are financed by issuing shares. This system is mainly designed for the protection of shareholders' rights. This conceptualisation is at the heart of the OECD's corporate governance principles. This contrasts with the continental European model, where the ownership structure is concentrated and firm activities are financed through bank credits.³¹ The desire to change the existing capital market structure, replacing it with sophisticated capital markets that provide a developed equity culture with widespread shareholding is another reason for applying the OECD Corporate Governance Principles. By applying the OECD principles, Turkey encourages a corporate governance landscape which is based on liquid, deep and efficient capital markets.

It is important to consider that governments play a key role as a driving force for reforms. The adoption of corporate governance recommendations should be done regardless of their national origins but with emphasis on their legal origin as this ultimately determines the corporate culture of a state. Corporate governance is mainly about the distribution of the power of control. This distribution may vary across states, since they differ in their political, historical and cultural backgrounds.³² Consequently, there is a strong possibility that using principles intended for a different corporate culture will result in principles that fail to apply. It is essential for a government to understand the corporate culture clearly and identify its main elements before transferring over corporate governance principles from another jurisdiction.

³¹ Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) 52(2) *Journal of Finance* 737, 769-771.

³² Marco Pagano and Paolo Volpin, 'The Political Economy of Finance' (2001) 17(4) *Oxford Review of Economic Policy* 502, 502-510. See also Marco Pagano and Paolo Volpin, 'The Political Economy of Corporate Governance' (2005) 95(4) *The American Economic Review* 1005-1030.

Investors cannot make efficient selection of equities and assess the potential risk of their investment unless there is continuous flow of reliable and accountable information about the company.³³ Accordingly, norms and regulations about transparency and accountability in legitimating managers' actions is the challenge. Regarding the Turkish business environment, implementation of corporate governance principles requires mandatory public regulation. However, the adopted corporate governance principles are commonly perceived as an aspect of private law.³⁴ At this point, the question to be answered is whether corporate governance is positioned as private law or public law under the law of Turkey.

Considering the origin of the corporate governance principles in Turkey, it is clear that corporate governance is understood as a regulatory instrument of the state because in an environment of largely family-controlled companies dominated by low free float rate in the market, the enforcement of corporate governance principles falls largely on the CMB. It is also essential to have extensive public enforcement for the implementation of corporate governance principles because private enforcement practices are not well developed in Turkey and depend on the reliability of mandated disclosure.³⁵ In such an environment, the implementation of corporate governance principles largely rests on public enforcement. This shows that Turkish corporate governance principles cannot be conceived as purely private as it exhibits aspects of regulatory role of the state.

³³ Marc Moore, *Corporate Governance in the Shadow of the State* (Hart Publishing, Oxford 2013) 58, 198

³⁴ Ibid 63

³⁵ OECD, *Supervision and Enforcement in Corporate Governance* (OECD Publishing, 2013), 93.

The economic function of the market economy was interrupted by the economic crisis, and the inadequate allocation of resources had led to state intervention in the Turkish economy.³⁶ To some extent, state interference can compensate for the weaknesses of the market disciplinary forces and the limitations in civil remedies. On the other hand, it may present some challenges since state intervention in corporate law issues, even for the protection of the well-being of the public, can be seen as interfering in the private sector in a free economy.³⁷ It is a fact that the economy is a dynamic and innovative environment given that new products, relations and contracts emerge almost every day. Company legislation should facilitate such innovations, taking into account the risks in the economy, thus enabling the smooth functioning of the capital markets. There are issues that cannot be regulated by law, or even if regulated, they would not be effective in practice. The view taken here is that companies would not be very keen to comply with certain corporate governance principles in Turkey because, as a cultural characteristic, the absence of legal sanctions acts as a deterrent. Therefore, it should be the duty of the state to determine the minimum requirements of corporate governance framework. This would facilitate the widespread implementation of the corporate governance principles. At the same time, it needs to be reminded that these corporate governance standards should not be firmly established and set in stone. The state should regulate the key contours of corporate governance framework, such as mandatory disclosure of company related information. For the internal affairs of companies, such as independent BoD, individual companies should use corporate governance principles voluntarily and freely depending on their particular occasions and challenges. Consistent with this idea is that the regulatory

³⁶ See Chapter 1 Section 4 pg. 37

³⁷ Moore (n. 33), 96.

power of the state should supplement the private enforcement of corporate governance in Turkey.

1.3 Key institutions with statutory powers and responsibilities Related to corporate governance

a. Capital Markets Board Regulations

The Capital Markets Board of Turkey was established in 1982.³⁸ It has an autonomous structure and it aims to restructure the Turkish capital markets according to the concept of increased competition in the international arena and the developments in other developed states. Since the CMB plays a leading role in setting corporate governance standards for publicly-held companies, the corporate governance framework in Turkey rests upon a 'public enforcement' model. The difficulty of public enforcement is to balance the use of supervisory power by the state through preventive measures with the urge to allow the market develop its own correction mechanisms. However, it can be argued that in an environment, where family ownership dominates, the free float rate is low and the legal system is not functioning well, private enforcement of corporate governance will not be effective. The case of Turkcell is a good example of the need for public enforcement.³⁹ The BODs of Turkcell failed to resolve a dispute among principal shareholders. As no agreement was reached, the general meeting was cancelled and shareholders were unable to receive a dividend for more than two years. The shareholders called for government intervention. Eventually, the CMB appointed three independent board members to Turkcell's board. In Turkey, the power of non-controlling shareholders to monitor the

³⁸ Capital Markets Board of Turkey,
<<http://www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=0&pid=0&submenuheader=-1>
accessed 12 June 2015

³⁹ The Economist, 'The Battle for Turkcell' 21 April 2012,
<http://www.economist.com/node/21553054> accessed 05 June 2015.

company and influence its policies is weak. In addition, domestic institutional investors have a limited presence in the capital market and the amount of shares held by foreign institutional investors in a company is generally too small to justify the cost of monitoring.⁴⁰ Considering that the monitoring function of shareholders is relatively weak under Turkish corporate culture, it can be debated whether private enforcement by shareholders is a powerful means to influence corporate behaviour. As a consequence, extensive public supervision by the CMB is an important tool for ensuring compliance with the corporate governance standards in Turkey.

The Corporate Governance Principles of the Capital Markets Board were issued in 2003.⁴¹ The principles did not make any significant changes as the obligations of listed companies continued as set out by the existing law. The aim of introducing these principles was to fill the gap of corporate governance implementation in Turkey. For this reason, the principles are applied on a 'comply or explain' basis, similar to the UK model of corporate governance. The response of the UK to corporate governance failures was not prescriptive and legislative, but a 'comply or explain' approach according to which the market imposes all the necessary sanctions.⁴² Such approach allows an interval of time for its implementation and attempts to encourage the adoption by shareholders by creating pressure.⁴³ The main strength of this method is that it gives flexibility to companies by eschewing a 'one size fits all' approach. Even though the voluntary approach of corporate governance has considerable strengths,

⁴⁰ Melsa Ararat and Muzaffer Eroğlu, 'Istanbul Stock Exchange Moves First on Mandatory Electronic Voting at General Meetings of Shareholders' (2012) Harvard Law School Forum on Corporate Governance and Financial Regulation, available at: <http://ssrn.com/abstract=2172964> accessed on 25 June 2015

⁴¹ Capital Markets Board of Turkey Corporate Governance Principles (n. 29)

⁴² Stelios Andreadakis, 'Research Notes: Regulatory or Non-Regulatory Corporate Governance: A Dilemma between Statute and Codes of Best Practice' (2008) 4(3) Journal of Contemporary European Research 253, 254.

⁴³ Sridhar R. Arcot and Valentina G. Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK' (2006) LSE Working Paper No.031 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=819784 accessed on 24 June 2015

one important question that needs to be asked is how Turkish companies reacted to this approach. In 2005, after ignoring the principles for two years following the initial launch, the publication of a corporate governance compliance report in the annual reports became a requirement for listed companies. Since the compliance reports do not need to be verified, some company reports comprise only a few pages even though the Capital Markets Board has introduced over 100 corporate governance principles, yet the same reports are published with little difference over the following few years.⁴⁴ It is obvious that CMB's expectation that shareholders would compel listed companies to comply with the principles was not fulfilled.

In the beginning, the 'comply or explain' rule did not cover all of the Capital Markets Board principles. Exceptionally, when the principles were first published, some principles were marked as pure recommendations that fell outside the scope of the 'comply or explain' rule.⁴⁵ In this case, a company was neither obliged to comply nor to explain in case of non-compliance. This shows that this arrangement was made with a view to allow time for companies to familiarise themselves with the new principles. Compliance with recommendations would be a difficult task for most companies to fulfil in the short-term, considering the characteristics of the Turkish corporate culture. Therefore, to prevent these difficulties undermine the new initiative and at the same time to encourage the widespread application of the principles, flexibility was given to companies. Nowadays, most of the recommendations in the CMB communiqué have become compulsory for listed companies. Although it is known that the Capital Markets Board Corporate Governance Principles would not suffice to

⁴⁴ See Reports on <http://www.spk.gov.tr/indexcont.aspx?action=showpage&menuid=10&pid=4> accessed 05.May 2015.

⁴⁵ See Capital Markets Board of Turkey Corporate Governance Principles (n. 29), the (R) letters on the sides of some of the Principles indicates that those are recommendations only.

radically or quickly transform companies, they did have a noticeable effect on the creation of a capital market culture among Turkish companies.

b. Borsa Istanbul regulations

Borsa Istanbul is the only stock exchange in Turkey. It is supervised and monitored by the CMB. Borsa Istanbul constitutes an important part of the Turkish capital markets.⁴⁶ To understand the magnitude of Borsa Istanbul, it will be useful to supply some indicators about it. Compared to the developed states' stock exchanges, such as the London Stock Exchange, which is one of the biggest and oldest stock markets in the world with a daily average trading volume of US\$4.7 billion and 2938 listed companies, Borsa Istanbul is a new and small market.⁴⁷ According to the 2011 annual report of the CMB, there were 98,191 joint stock companies in Turkey and 628 joint stock companies registered with the CMB. The shares of 373 of them are traded on Borsa Istanbul. From these numbers, it is understood that Turkey is facing difficulties in bringing its existing companies into its stock exchange. The main reason is the additional costs and responsibilities that companies have to endure – something family companies prefer not to do. The trading volume of Borsa Istanbul is US\$694,8 billion.⁴⁸ The interest of foreign investors in Borsa Istanbul increased towards the end of 2007, as a result of a comparatively stable political and economic environment as discussed in the previous chapter. However, the purchasing power of foreigners in the foreign markets was affected by the global financial crisis that emerged in 2008 and

⁴⁶ Borsa Istanbul, About Borsa Istanbul < <http://www.borsaistanbul.com/en/corporate/about-borsa-istanbul/about-us> > accessed 24 June 2015

⁴⁷ London Stock Exchange Group, 2011 Annual Report <https://www.lseg.com/sites/default/files/content/documents/lseg-annual-report-2011.pdf> accessed on 25 June 2015

⁴⁸ Capital Markets Board of Turkey Annual Report (n. 16)

their number has inevitably fallen.⁴⁹ Recent strategic partnership agreements signed between BIST and NASDAQ OMX Group, Kazakhstan Stock Exchange and London Stock Exchange Group indicate that Borsa Istanbul is being gradually integrated into other financial markets. These agreements not only bring Borsa Istanbul in line with the global standards of stock exchanges in terms of technological infrastructure but also strengthen its position. These agreements are undoubtedly important in terms of enhancing the reputation of Borsa Istanbul globally and raising the interest of foreign investors in Turkish companies.⁵⁰

Borsa Istanbul started to calculate the BIST-Corporate Governance Index, in which companies applying the Capital Markets Board principles are included, in order to motivate publicly-held companies to implement corporate governance in 2007.⁵¹ Comparing the performance of BIST-100 and BIST-Corporate Governance Index since the beginning of 2009, BIST-Corporate Governance Index has increased by 265%, whereas BIST-100 did so by 222%.⁵² Investors in the BIST-Corporate Governance Index earned approximately 9% more profit each year. These results reflect the fact that companies complying with corporate governance principles have higher average investment returns than other companies in Borsa Istanbul. There is a strong possibility that the corporate governance index will make implementation of corporate governance more widespread, and improve the investment environment by promoting transparency, accountability and fairness among listed companies. These

⁴⁹ Central Registry Agency, Echange Trend Reports (1 June 2012), 9, https://www.mkk.com.tr/wps/wcm/connect/2baf295f-d91d-45f2-ad2b-34b23bd5cafc/Borsa_Trendleri_Raporu_I.pdf?MOD=AJPERES accessed on 23 June 2015

⁵⁰ Namlı Çalışkan and Turan Icke, 'Turkish Corporate Governance Principles and its Implications for ISE Corporate Governance Index Companies' (2011) 11(1) Journal of Accounting and Finance 60,73.

⁵¹ See Borsa Istanbul, for the calculation of Corporate Governance Index <http://borsaistanbul.com/en/indices/bist-stock-indices/corporate-governance-index> accessed 25 June 2015.

⁵² Vahdettin Ertaş, VII. Uluslararası Kurumsal Yönetim Zirvesi Açılış Konuşması (VI. International Corporate Governance Conference Opening Speech) 15 Ocak 2014, < <http://www.spk.gov.tr/duyurugoster.aspx?aid=20140115&subid=0&ct=f> accessed 09 June 2015

can act as further incentives for foreign investors as they reflect a more accountable and transparent investment environment as well as better investment returns.

2. The corporate governance pillars in the Turkish legal system

In this section, the deficiencies of the current legal system that most significantly affect corporate governance in Turkey will be considered. The CMB Principles will be examined in detail as well as Turkish company and capital market law. As CMB Principles draw on OECD Corporate Governance Principles, comparisons will be drawn in this section, and reference will be made to previous studies focusing on the level of implementation of Corporate Governance Principles in Turkey.

a. Equal treatment of shareholders

The protection and empowerment of shareholders is an important issue, since they are one of the most influential groups of stakeholders in corporate governance. According to the OECD Corporate Governance Principles, shareholders within the same group should be treated equally.⁵³ Emphasis is placed on the equitable treatment of all shareholders and companies are expected to find effective methods to obtain redress for grievances at a reasonable cost and without excessive delay. If voting rights in the same group or between groups are to be modified, this should take place with the implicit approval of all the shareholders. This approval is a way to prohibit a certain group of shareholders to have power in management, especially in states, such as Turkey, where controlling shareholders can affect corporate affairs to their own advantage.

⁵³ OECD Corporate Governance Principles, Part 2/III The Equitable Treatment of Shareholders, <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf> accessed on 25 July 2015 40-45

The key aspect of the obsolete TCC concerned the primacy of the company, with its interests being placed before those of the shareholders.⁵⁴ When the old Commercial Code was enacted, state owned enterprises dominated the economy. In a small number of existing joint-stock companies, the controlling shareholders were directly represented on the board. The primacy of the company provided a basis for resolving conflicting interests between controlling shareholders and minorities.⁵⁵ Since the number of joint-stock companies and investors were fewer when the obsolete TCC was enacted, little importance was placed on the provisions regarding shareholder protection, equal treatment and disclosure of information. The Articles of Association formed the document primarily governing the rights of shareholders.

Eventually, due to the weak levels of shareholder protection in Turkey, equal treatment of minority shareholders became a serious issue in relation to corporate governance.⁵⁶ No provision was put in place to directly regulate the principle of equal treatment of shareholders in the obsolete TCC, apart from an indirect article in CML.⁵⁷ According to Article 12 of CML, the power to restrict the right of shareholders to obtain new shares should not be used to cause inequalities among shareholders. In order to secure equal treatment of shareholders, companies need to enhance the disclosure of information, and prevent both managers and controlling shareholders from abusing their position. Despite the fact that CMB Corporate Governance Principles acknowledge the equal treatment of shareholders, this principle

⁵⁴ Melsa Ararat and Hakan Orbay, 'Corporate Governance in Turkey; Implications for Investment and Growth' available at <<https://research.sabanciuniv.edu/801/1/stvkaf07a67.pdf>> 17

⁵⁵ Ibid 18

⁵⁶ The Institute of International Finance, Inc., 'Corporate Governance in Turkey – An Investor Perspective' (2005) <
http://forecasturkey.com/Articles/Multilateral%20Agencies/international%20agencies/IIF/IIFCorpGovTurkey_0405.pdf> 7

⁵⁷ The Republic of Turkey Capital Markets Law of Turkey Law No.6362 (6.12.2012) Article 12(4)

became less effective as a consequence of the presence of controlling families within companies.

In Turkey, the system of ‘one share one vote’ applies, so each share is entitled to one vote. The principles of CMB Corporate governance call for one share, one vote, and although privileges *per se* are not completely ruled out, it states that voting privileges should be avoided.⁵⁸ However, Capital Markets Law states that privileged shares, classes of shares carrying different rights with regard to voting, participation in dividends and assets in the event of liquidation, can be issued if there is a provision in the Articles of Association of the company.⁵⁹ Thus, despite shares nominally being of equal value, preferential shares confer rights over the owners of ordinary shares. Privileged shares can be issued for public offerings because they do not violate the principle of equality between the shareholders. The most likely reason for the existence of privileged share is the family dominated ownership structure of Turkish companies. Most commonly, companies increase their capital through public offerings, only if the dominant shareholders have guarantees that they do not lose their control over the management. Therefore, controlling shareholders are primarily in possession of preferential shares, with multiple voting rights, and they have the ability to assign various types of privileges by Articles of Association to different classes of shares.⁶⁰ The results of the 2004 CMB survey revealed that 42% of public companies have share classes containing a privilege of nominating board members, making this the most commonly used privilege in Turkish companies, with the rest including voting rights (21%) and rights to nominate the statutory auditors (18%).⁶¹ Since the

⁵⁸ CMB Corporate Governance Principles, (n. 29) Part I (4.5)- Shareholders/Voting Rights

⁵⁹ The Republic of Turkey Capital Market Law, (n. 57) Article 18.

⁶⁰ Burçin Yurtoğlu, Ownership, Control and Performance of Turkish Listed Firms’ (2000) volume 27 (2) *Empirica*, 198

⁶¹ Ararat and Orbay, (n. 54), 15

TCC does not pose any limit on the types of privilege, the right to nominate board members under Turkish law can be allocated to a group of shares. This type of privilege enables a certain class of shareholders to nominate, and elect, board members, regardless of the percentage of their participation in equity. In this case, board members can be elected in the general assembly by members nominated by the privileged shareholders.⁶²

However, issues arise due to privileged shares being, in practice, rarely floated.⁶³ As a result of the use of privileged shares, families, as controlling shareholders, exercise excessive control over companies, thus limiting the executive powers of professional managers, despite the fact that they do not own a majority of the company's share capital. This increases concentration of corporate ownership structure and diminishes the role of the market in protecting shareholders' interests. Such devices are the means of preventing a change of control in Turkey's corporate culture. Ararat and Orbay note that, despite this being a cultural issue, the effect of a weak judicial system and weak law enforcement mechanisms should not be ignored.⁶⁴ The obsolete TCC had no restrictions on the granting of privileges, while the CMB Principles discourage the issuance of these shares.

The use of voting rights is one of the main mechanisms for shareholders to have a voice when it comes to the management of companies. According to Article 360 of the obsolete TCC, shareholders can exercise their voting rights by proxy.⁶⁵ However, the same Article permits companies to prohibit its shareholders from appointing

⁶² Sibel Hacımahmutoglu, 'The Problems of Minority Protection and Their Solutions within the Legal Framework in Turkish Corporate Governance' (2007) 8(2) *Journal of Banking Regulation* 131, 138

⁶³ By 2015, there were only 3 companies with share classes of privileges in BIST. See Borsa Istanbul Equity Market Companies website <http://www.borsaistanbul.com/sirketler/islem-goren-sirketler/pay-piyasasi-sirket-bilgileri> accessed on 21 November 2015

⁶⁴ Hacımahmutoglu, (n. 62) 32

⁶⁵ The Republic of Turkey, Obsolete Turkish Commercial Code Law No. 6762 (9 July 1956) Article 360

proxies through the insertion of relevant provision in the Articles of Association. Likewise, CML failed to prevent companies from inserting relevant provisions in their Articles of Association.⁶⁶ On the other hand, the aim of the CMB Principles is to enable shareholders to use their votes. Therefore, the CMB Principles state that any provision with the potential of preventing voting by the use of a proxy should not be included in the company's Articles of Association.⁶⁷ This is a clear example of conflict between the TCC and CMB principles. Since the CMB principles have no legally binding force, companies are able to prohibit voting by proxy through their Articles of Association. This has proved to be a major problem for investors, as, in order to exercise their right to vote, they are required to be physically present at the general assembly meeting.

In Turkish business culture, it is a necessity to protect the minority interest against the majority shareholders' control functions to attract the investors. The rights of minority shareholders are defined by the law-maker as the rights granted to shareholders owning at least 10% of the company's share capital or less than 10% of the share capital if stated in the Articles of Association. This percentage is 5% of share capital in listed companies.⁶⁸ Minorities were given the right to compel directors to convoke an Extraordinary General Meeting; require directors to add an item to the agenda for General Meetings; take legal action against the directors, should they be in breach of their duties. However, it should be pointed out that minority shareholders could exercise these rights provided that they reach the requisite threshold. In other words, when the requisite threshold exists, individual investors could not be able to exercise these rights. This threshold has become an obstacle to the ability of minority

⁶⁶ Regulation Concerning Proxy Voting and Takeover Bid in Listed Companies Serial IV, No.30, T.C. Resmi Gazete No. 25130 (2003)

⁶⁷ CMB, Corporate Governance Principles, (n. 29) Part I (4.6)-Shareholders/Voting Rights

⁶⁸ Obsolete TCC, (n. 65) Article 366

shareholders to exercise their rights. This Article of the obsolete TCC, along with the issues it causes for investors, will be discussed in the next chapter.⁶⁹

The right of the shareholders to obtain relevant and material information on the corporation on a timely and regular basis is one of the basic shareholder rights mentioned in the OECD Principles.⁷⁰ The right to obtain information was regulated in a very basic manner in the TCC. The obsolete TCC did not provide any efficient functional mechanisms to guarantee effective enforcement of this right.⁷¹ Shareholders are able to exercise their right to information in the general assembly. Shareholders obtained information about the companies by the board's annual reports and the company's financial statements that were available for auditing before the annual general assembly.⁷² However, the former TCC neither provided standards in relation to the quality and content of the information to be supplied, nor legal sanctions in the event that such requests were refused. Despite the fact that CMB Corporate Governance Principles contain provisions regarding the legal consequences of refusal to provide the requisite information, this principle does not have any legal effect, since the legal consequences cannot be determined by soft law. It appears that, due to this legal deficiency, the courts have been unable to enforce the CMB Principles. The previous law gave no opportunity to investors to apply to the court on the grounds that the information they had requested had been refused. This rendered investors unable to ensure they were fully informed about the companies' operations.

It is clear that the previous TCC was not sufficient in providing a fair structure for the shareholders to exercise their rights and ensuring effective communication with the

⁶⁹ See Chapter 4 Section 2.1 pg.162

⁷⁰ OECD Corporate Governance Principles (n. 53), Part II(A) on the Rights of Shareholders and Key Ownership Functions

⁷¹ Ararat and Orbay, (n. 54), 28-29

⁷² The obsolete TCC, (n. 65) Article 362

management. Even though shareholders have legal rights, they have difficulties in exercising them. Regarding the shareholders principle of corporate governance in Turkey, it is widely accepted that the exercise of shareholders rights and the effective communication and interaction with management was not possible and that there existed several shortcomings in the exercise of shareholder rights.⁷³ These circumstances led to discrepancies between the Turkish business culture and the OECD Corporate Governance Principles. These discrepancies form an obstacle for building foreign investors' trust and confidence, since they have, in practice, no opportunity to protect themselves from oppression by the controlling shareholders.

b. Stakeholder rights

The OECD Principles state that the corporate governance framework should recognise stakeholder rights.⁷⁴ The Principles also place emphasis on co-operation between stakeholders and corporations in creating wealth, jobs and sustainability. The performance-enhancing principle for employee participation in the OECD basically aims to increase stakeholders' participation in management.⁷⁵ This principle promotes giving incentives for employee participation in management which can be achieved by distribution of shares to employees or the presence of employee representatives in the BOD.

The CML does not make reference to the rights of stakeholders, and nor does the obsolete TCC. However, listed companies are required to disclose their policies related to the treatment of the primary stakeholders, e.g. creditors, customers,

⁷³ Cüneyt Yüksel, 'Recent Developments of Corporate Governance in the Global Economy and the New Turkish Commercial Draft Law Reforms' (2008) 3(2) *Journal of International Commercial Law and Technology* 101 108.

⁷⁴ OECD Corporate Governance Principles (n. 53), Part IV(C) on the Role of Stakeholders in Corporate Governance

⁷⁵ Ibid Part IV(A)

employees and society in general. These policies of the company should be prepared by the board of directors, submitted to the general assembly meeting for information. In line with OECD Principles, the CMB Principles contain a section relating to stakeholders, which outlines the interests of individuals who are not shareholders.⁷⁶ When referring to stakeholders, the CMB Principles do not lay down any detailed obligations, and generally focus on employees. Career planning, occupational skills training, improvement of working conditions and communication with the workers about the company's operations were found to be common business practices, whereas the level of distribution of company shares and profit to workers and workers' representation in the management board are low.⁷⁷ Turkish law provides no mechanism for employee participation in company management, and neither stock option, nor ownership by employees are regulated under Turkish law. In a business environment dominated by family ownership where management is authoritative and any outside interference to management is regarded as a constraint, it would be naïve to expect high employee participation in management.

c. Disclosure and transparency

Separation of ownership and control resulted in that managers possess more information about the companies than the shareholders.⁷⁸ Therefore, public disclosure, for example, informing the public through financial statements, is a fundamental function that provides adequate and accurate information about the economic situation of the company and reduces information asymmetry. In accordance with the

⁷⁶ CMB Corporate Governance Principles (n. 53), Part III-Stakeholders

⁷⁷ Arcan Tuzcu and Ali Fıkırkoca, 'Corporate Governance Approach of Turkish Companies Operating in the Istanbul Stock Exchange: The Case of an Emerging Market Economy in an Age of Capitalist Diversity' (2005) (4) *Problems and Perspectives in Management* 154,163.

⁷⁸ Stephen Lim, Zoltan Matolcsy and Don Chow, 'Association between Board Composition and Different Types of Voluntary Disclosure' (2007) 16(3) *European Accounting Review* 555, 558

information provided by public disclosure, investors can shape their own investment strategy.

Under the OECD principles, there are two kinds of disclosure.⁷⁹ The disclosure of information within the defined minimum limits is ‘mandatory disclosure’. This information must necessarily be disclosed; in which form, to whom and when they should be disclosed is detailed by the principles. Any other disclosure of information, which exceeds the defined limits in terms of content or amount as decided by the management of the firm, is ‘voluntary disclosure’. Voluntary disclosure represents the free choice of the management to decide which information needs to be disclosed. In theory, voluntary disclosure should present negative information as well as positive related to the companies. Thus, the investors would be informed about other all company related risks which may have effect on their decisions.

Due to the nature of Turkish business, disclosure was not considered to be in the best interests of the public prior to the enactment of the new TCC. When the obsolete TCC was first enacted, the state was the primary user of company related information for tax purposes. Controlling shareholders had privileged access to all company information.⁸⁰ In addition, there was no regular practice of credit rating, due to companies organising their own finance, either internally or through means of bank loans. Consequently, there was no incentive to regulate the disclosure of such information. Before the enactment of the new TCC, rules regarding disclosure and transparency of companies were purely tax driven

Financial disclosure is very important for foreign investors as it facilitates an understanding of the financial situation of the corporations. In Turkey, the emphasis

⁷⁹ OECD Corporate Governance Principles (n. 53), Part V, 49.

⁸⁰ See Chapter 4 Section 1 pg.147

for financial disclosure has always been limited, and accounting and audit standards were extremely low and poor. The obsolete TCC set just the minimum requirements for book-keeping;⁸¹ however, this did not improve the preparation of financial reports, as the primary concern of these requirements was taxation. The standards, according to which the financial statements are prepared, how frequently they will be published and which information will be included are specifically mentioned in the CMB communiqués for listed companies.⁸² All the listed companies under the CMB are obliged to prepare their annual and interim financial statements or consolidated financial statements in accordance with the standards set out by the BoD. Thus, investors were able to access accurate, timely and complete information concerning listed companies. However, weakness in law enabled non-listed companies to create hidden reserves.⁸³ This enabled controlling shareholders and the directors to conceal the company's actual financial situation and performance. The ability to create hidden reserves enabled controlling shareholders to channel company profits between parent and subsidiary companies, using pyramidal structures. This became a major issue for the protection of minority shareholders under Turkish law. In creating an adequate legal framework, it is important to provide protection for investors' interests and eliminate hidden reserves.

The responsibility to issue accounting and auditing standards compatible with international standards in order to modernise national accounting standards was given to the Turkish Accounting Standards Board (TASB), an autonomous entity under the

⁸¹ The Obsolete TCC, (n. 65) Article 66-86

⁸² The new TCC No.6102 (n. 23), Article 514-518 and Capital Markets Boards, Communiqué on Principles of Financial Reporting in Capital Markets, Serial: XI, No: 29, Communiqué on Accounting Standards in Capital Markets Serial: XI No: 28 and Seri: VIII, No: 54 Communiqué on Principles Regarding Public Disclosure of Special Cases and Communiqué Regarding Principles of Submitting Electronically Signed Information, Documents and Notifications to the Public Disclosure Platform Serial: VIII, No:75.

⁸³ Hacımahmutoğlu, (n. 62) 145

authority of CMB. However, its legitimacy was not supported in law. Accounting standards issued by CMB are similar to International Financial Reporting Standards (IFRS). The adoption of IFRS can be regarded as a first step to increase trust in the reliability of financial reporting and thus attract foreign investors to Borsa Istanbul.

There were no general audit standards that could be applied to all companies. CMB made significant progress in improving audit standards, and authorised a number of agencies to audit companies in different sectors. However, each agency defined its own standards, thus differing in terms of their views on the purpose and content of an audit. It has also been reported that the majority of audits undertaken were related to tax certification in Turkey.⁸⁴ A discussion of the deficiencies of the accounting and auditing system, along with a detailed analysis of the old law, will be undertaken in the following chapter.⁸⁵ Suffice it to say here that, as the transparency and accountability offered to investors improves is increased, the importance of accounting and auditing standards. As discussed in the Introduction, reform in the area of corporate governance is beneficial for the improvement of the investment environment with Turkey, provided that it also improves the level of transparency, disclosure and accountability.

d. Board of directors and their responsibilities

The OECD Corporate Governance Principles indicate that BoD should be responsible for the strategic guidance of the company, effectively monitor the management, and be accountable to the company and the shareholders.⁸⁶ It is advised that the members of the board should behave on a fully informed basis, with due diligence and care, in good faith, and in the best interests of the company and the shareholders. The BOD

⁸⁴ Ararat and Orbay, (n. 54) 30

⁸⁵ See Chapter 4 Section 1 pg. 147 and Section 2.1 pg. 162

⁸⁶ OECD Corporate Governance Principles (n. 53), Part 2 (VI.), 58.

should treat all shareholders fairly when board decisions affect different shareholder groups differently. However, the responsibilities of BoD are not limited to the shareholders only. BoD are also responsible to the stakeholders of the company as well as the community.⁸⁷

Turkish joint stock companies follow the one-tier board system. Under the obsolete TCC, board members were required to be shareholders or their representatives and were nominated, appointed and dismissed by shareholders, with a simple majority at the general assembly.⁸⁸ This means that in companies with a controlling block of shareholders, all board members can be elected by the majority shareholder. In addition, Article 316 of the obsolete TCC stated that shareholders are able to dismiss directors at any time, even if directors have been appointed by the Articles of Association.⁸⁹ This has resulted in the disqualification of Board, and a disregard for the fact that a company is a separate legal entity, due to Board owing their allegiance to the controlling shareholders, rather than to the company.⁹⁰

As a result of the concentration of ownership in the hands of families, the duties of directors have not been adequately developed. According to a report prepared by the Institute of International Finance, Boards, in practice, generally consist of representatives of controlling shareholders. The CEOs fail to establish a strong position, since the controlling shareholders are directly involved in day-to-day management through the directors.⁹¹

⁸⁷ Ibid

⁸⁸ Obsolete TCC, (n. 65) Article 312

⁸⁹ Ibid Article 316

⁹⁰ According to the obsolete TCC (n. 65) Article 332,334,335 and 337, the duty and responsibility of BoD was to the company

⁹¹ See IIF Task Force Report Corporate Governance In Turkey, (n. 56)

The TCC did not impose any requirements regarding the independency of BoD. Unlike the TCC, the Capital Markets Board Corporate Governance Principles highlight the importance of independent directors and advise the companies to have independent board members, who can perform their duties without being under any influence.⁹² Yet, considering the meaning of independent members in corporate governance only from a financial aspect is inadequate. It is expected that these members should be independent in terms of conduct and behaviour and should be objective in dealing with all company related issues. Foreign investors reduce their information obtaining cost through investing in companies with lower information asymmetry. The existence of independent directors may assist in limiting the domination of controlling shareholders over the Board as well as reducing the information and monitoring costs of investors. Regarding listed companies, the results of research, which examined the BoD structure in BIST-50 companies, indicate that 56,2% of BIST-50 companies did not have an independent member on their boards.⁹³ Even though 38% of these companies had two or more independent board members, only 9 of them could achieve the one-third ratio set out by the Capital Markets Board Corporate Governance Principles. A more recent research supports the findings of above-mentioned research.⁹⁴ The results show that the implementation of independent BoD was very limited in Turkish companies and independent members did not take up enough places on BOD. Even if the suggested ratio of independent directors is achieved, considering the ownership structure, the independence of these directors

⁹² CMB Corporate Governance Principles, (n.29) Part-IV (3.3.5)

⁹³ Cem Cüneyt Arslantas and Mine Afacan Fındıklı, 'İMKB-50'de Yer Alan Şirketlerin Yönetim Kurulu Yapılanmaları' (The Board Structure of Firms Listed in ISE-50 Index) (2010) 39(2) Istanbul University Journal of the School of Business Administration 258, 269.

⁹⁴ İrge Şener, 'Halka Açık Aile İşletmelerinin Yönetim Kurullarında Meydana Gelen Değişimler' (Changes Occuring in the Boards of Directors in Publicly Held Family Companies) (2012) in İstanbul Kültür Üniversitesi, Aile İşletmeleri ve Girişimcilik Uygulama ve Araştırma Merkezi, 5. *Aile İşletmeleri Kongresi Kongre Kitabı* (İstanbul Kültür Üniversitesi Yayınları Yayın No169), 167.

could still be questioned, because it is difficult to be confident that the market for independent BoD will be perfect in the Turkish business environment, where personal contacts with governmental bodies and members of dominant families are important.

According to the obsolete TCC, the board was required to perform its activities with diligence, care and good faith, and to avoid conflict of interest.⁹⁵ The problem with this law is that it, in fact, did not introduce a standard that should be considered for the comparison. In other words, it did not provide a clear-cut with regard to the duty of care. Since this element was missing in the rule, the question whether the rule was applicable can be answered negatively. Fiduciary duties of directors should be adequately regulated by Turkish law so as to establish efficient corporate governance rules for minority protection.

Under the CMB principles, the obligation to issue a corporate governance compliance report is one of the requirements of BoD. This raises a question as to whether directors should be held liable for their choice not to comply with the Principles. According to Article 336 of the obsolete TCC, each BoD was liable for the failure of the company and of its shareholders to fulfil any duty imposed on them by law.⁹⁶ The wording ‘duty imposed by law’ indicates that the Board can be held responsible for the duties stemming from the binding rules and communiqués. However, the CMB principles are not a part of binding law and there is no legal obligation to comply. Thus, Boards cannot be held liable for non-compliance. Thus, it is understood that the obligation to issue a corporate governance compliance report was simply a means to encourage companies just to adopt them in line with corporate governance principles, and was not an obligation aimed at protecting the rights of individual shareholders. As a result,

⁹⁵ Obsolete TCC, (n. 65) Article 320

⁹⁶ Obsolete TCC, (n. 65) Article 336(1)

corporate governance principles as a soft law instrument would be insufficient to protect the rights of investors.

Corporate governance practices in Turkey have had serious deficiencies that possibly prevent companies from accessing finance. Examining the former TCC, it is clear that the Turkish legal framework has had a number of weaknesses when it comes to the protection of the interests of minority shareholders. It should be remembered that Turkish corporate culture relies on the concentration of ownership, which makes self-regulatory enforcement ineffective. Indeed, the protection of investors' interests requires an adequate legal and regulatory framework, as well as the strict enforcement of laws. Considering the Turkish business culture, the conversion of self-regulatory CMB principles into legally binding provisions would have positive implications for the improvement of the protection for investors.

Turkey is currently experiencing an ongoing reform in its Commercial Code. The new TCC, which will be detailed in the next section, aims to change the management mentality of companies and provide the basis for an effective voice in management for all investors, which would establish a better investment environment for foreign investors. It is highly likely that the new Code will not immediately empower shareholders because these issues are related to existing legal arrangements as well as the business culture and environment. However, the innovations of the new TCC are suitable for providing better protection of shareholders' rights.

3. The new Turkish Commercial Code

In the twenty-first century, it is not possible for traders to keep up with the global economic developments with a commercial code that dated back to 1957. Therefore, a

modern commercial code, compatible with the new trade regime, became necessary for Turkey. Correspondingly, the need for the TCC to be harmonised with the EU legislation, coupled with the outdated nature of the TCC for regulating financial and capital markets and facilitating commercial life, highlighted the need for an update.⁹⁷ The new TCC came into force on 1 July 2012, and introduced fundamental changes that would substantially restructure Turkish commercial law.

The aim of the new TCC is to provide shareholder empowerment, make use of information technology tools and, in addition, regulate commercial relations in line with the most recent economic developments, while bringing together Turkish law with the EU *acquis*.⁹⁸ For this reason, the new TCC aims to initiate a new era for companies, in order to lay the foundations for them to become corporations with professional management understanding, increase competitiveness of the financial markets, and foster public trust, transparency and sustainability. The new Code was designed to bring the following elements to Turkish commerce: improvements in the investment environment and in doing business, the adoption of corporate governance principles in Turkish companies, accountability and transparency. It also aims to appropriately serve information needs of the society.⁹⁹ As a result, transparency in the investment environment will increase. This would help investors to be better-informed about the corporate activities.

The new TCC paved the way for the integration of corporate governance principles into Turkish law. It seems fair to suggest that Turkey met the integration requirements

⁹⁷ Yüksel (n. 73) 106.

⁹⁸ PricewaterhouseCoopers, 'Draft Turkish Commercial Code: A Blueprint for the Future' < http://www.turkey-now.org/db/Docs/taxguide2009_pwc.pdf > accessed 05 June 2015

⁹⁹ Ünal Tekinalp, 'Türk Ticaret Kanunu Tasarısının Sermaye Piyasasına ve Sermaye Piyasası Kanununa İlişkin Hükümleri' (Provisions of the new Turkish Commercial Law on the Capital Market and Capital Market Law) in Korkut Özkorkut, *Impacts of the Draft Turkish Commercial Code on Capital Markets from an EU Perspective* (Banka ve Ticaret Hukuku Araştırma Enstitüsü, 2010), 21.

regarding corporate governance of the EU with the new Code given that it has demonstrated a noticeable change in the regulation of capital protection, public disclosure, transparency and accountability, and protection of stakeholders' rights as well as shareholders' rights. The new TCC does not include a set of rules, as it happened with the CMB communiqué, but instead has concretized the basic principles that are the foundations of corporate governance. However, the Capital Markets Board Principles, which were unable to make any headway into the business culture for so long time, showed that strict enforcement, as opposed to 'comply or explain', is necessary for Turkey. Before the adoption of the new Code, corporate governance was an issue for public limited companies that were listed on the Borsa Istanbul and were subject to Capital Markets Law. The new Code requires that all public limited companies should follow the corporate governance principles. Every article in the new TCC is mandatory, unless otherwise expressly provided. The Capital Markets Board Corporate Governance pillars, especially transparency and public disclosure, have been marked as mandatory under the new TCC. Moreover, certain basic corporate governance principles that are not regulated under the Capital Markets Board principles, such as the risk management committee and appointments committee, have been added in the new Code. This means that the non-legally binding 'comply or explain' principle was replaced by binding rules under the new Code. The reforms of the new TCC play a key role in incorporating the corporate governance principles into the Turkish business environment, its investors and society as a whole. However, the concentrated ownership structure of Turkish companies puts shareholders in a weak position to do so. Therefore, turning the principles into obligatory guidelines was necessary.

The TCC was completely reformed but only the corporate governance related articles will be discussed here, since the remaining are not within the scope of this Thesis.

A major change in the new Code concerns the number of shareholders. This is important as the number of shareholders is directly related to corporate governance. Under the previous TCC, a minimum of two partners for a limited liability partnership and a minimum of five shareholders were required to incorporate a joint stock corporation. The new Code reduces the number of shareholders to one (natural or legal person) shareholder both for joint stock corporations and limited liability partnerships.¹⁰⁰ It can be suggested that this change will enable legal honesty and realism, because it will prevent the occurrence of fake shareholders with very small stakes, such as 0.001%, for the establishment of the company simply for the purpose of meeting the minimum shareholder requirement imposed by the previous TCC. Moreover, foreign natural or legal persons will be able to establish a single shareholder company and invest as the owner of a single shareholder company in Turkey without any other partner. This will make corporations more accessible to foreign investors and reduce the risk of deception.

Protection of shareholder rights is one of the basic pillars of corporate governance. The new Code made drastic changes to shareholder rights, putting emphasis on shareholder democracy. To begin with, equal treatment of shareholders is formed under the basic principles of the TCC and has been recognized as one of the fundamental rights.¹⁰¹ Article 357 aims to limit the subjective and arbitrary decisions and practices of the controlling shareholder in joint stock companies. However, this Article refers to shareholders only, as stakeholders are excluded. This indicates that,

¹⁰⁰ The new TCC No. 6102 (n. 23) Article 338 for joint-stock companies and Article 573 for limited liability partnerships.

¹⁰¹ Ibid Article 357.

as suggested before, priority is given to shareholders in the Turkish corporate governance system.

In Turkey, the fact that the company has a separate legal entity was ignored. The preamble of Article 358 stated that before the entry of the New TCC into force, the shareholders could borrow from the company. This was resulting in situations in which loss of share capital could occur.¹⁰² Thus, this article aimed to prevent controlling shareholders from using the capital of the company for their personal business because such behaviour has an impact on the reliability of the company and violates the other shareholders' interests. In this way, other shareholders can be protected from the misuse of company profit by controlling shareholders. In this regard, the new TCC resolved that it is unlawful for shareholders to borrow funds from the company unless their mature debt arising from capital commitments was paid.¹⁰³ Pursuant to the relevant article, shareholders who pay all their mature debt may be in a state of borrowing from the companies whose income covers the loss from previous years. Thus, the unlimited borrowing power of shareholders has been limited to an extent. Even though this Article was initially intended to prohibit money withdrawing, because of the company ownership structure and following much public discussion, the final version that came into force provides a limitation, not a prohibition.

Under Turkish law, voting preference can involve different voting rights to different categories of shares that have equal nominal value, even though it is known that voting preference goes against corporate governance principles. The new TCC does not prohibit voting preference, but Article 479(2) limits the maximum number of

¹⁰² The Preamble of Turkish Commercial Code Law No. 6102, Article 358

¹⁰³ The new TCC, (n.23) Article 358.

voting rights that can be given to a share up to fifteen.¹⁰⁴ It is believed that this exemption, on the one hand, safeguards the incentive of companies with a controlling shareholder to become listed as they still have more power than non-family owners and, on the other hand, increases the incentive for investors because the family-member shareholders will have limited power. On the other hand, this limitation has some exceptions. The 1:15 limitation does not apply, if the company is in the process of improving and strengthening good corporate governance principle, or in the presence of a valid reason. In this case, more voting rights can be given to professional managers by a court decision.¹⁰⁵ The new TCC intends to change the perception that the life of the companies is associated to the life of their founders and allow continuity to the companies. Professional management is one of the conditions of being incorporated, and the decisions of the management should be independent of controlling shareholders. In this case, voting rights given to professional managers can play an important role in the implementation of the management decisions instead of those of the controlling shareholders. The voting preference rights that professional have managers through the shares they held ensure the possibility to go beyond the voting power in the family-owned corporations and provide professionalization.

The early risk identification committee has been introduced for the first time with the new TCC. The publicly-held companies are obliged to form an early risk identification committee and corporate risk management systems. Non-publicly held companies are not required to establish such systems, unless the external auditor considers it necessary. The early risk identification committee evaluates the risk situation of the company, points out the risk and finds remedies.¹⁰⁶ The purpose of

¹⁰⁴ Ibid Article 479.

¹⁰⁵ Ibid Article 479(2).

¹⁰⁶ Ibid Article 378.

risk management should not be to eradicate the risks that could occur from the activities of the companies, but instead to take calculated risks compatible with the organization culture and ensure the healthy growth of the companies. It is obvious that this provision reinforces disclosure by increasing effective reporting and as a result enhances the implementation of corporate governance principles in publicly-held companies. However, the main problem is that there is not an objective criterion in determining whether there is such a need for non-publicly-held companies. It is a fact that companies differ from each other by their size and nature of activity. Considering that there exist different kinds of risks in commercial life, it can be stated that determining criteria should become important. It can be suggested that the risk management measures also being applied in non-public companies would contribute to the overall economic welfare by increasing the company productivity and sustainability. This would also facilitate the widespread incorporation of corporate governance in the business culture.

In the previous TCC, there were a number of provisions preventing electronic shareholder meetings. Investors were faced with the obstacles of cost or physical distance to attending general meetings.¹⁰⁷ In practice, attending meetings could be a significant challenge for an overseas-based shareholder. This problem meant that many individual investors could not use their rights effectively. Regarding the percentage of foreign shareholdings in Borsa Istanbul, being unable to participate in general meetings could be a reason for low shareholder participation. An improvement to the new TCC for investors is that the general assembly can be done completely electronically, or some of the members may physically attend while the remaining

¹⁰⁷ Saim Kılıç, ‘Türk Ticaret Kanunu Tasarısının Halka Açılımlara Etkisi’ (The Impact of the Draft Turkish Commercial Code Initial Public Offerings) (2010) Anonim Şirketler ve Sermaye Piyasası Hukukunda Güncel Gelişmeler Türk – Alman Uluslararası Sempozyumu 18, 26.

members may participate electronically.¹⁰⁸ Online general assembly meetings, which could be a solution to this crucial problem especially for foreign-capitalized companies will be discussed in the next chapter.

The monitoring system of the financial statements has been completely changed with the new TCC.¹⁰⁹ The new articles clearly provide that the new TCC has shifted from tax accounting to information accounting, which will better serve an information society.¹¹⁰ It is stated that auditing must be carried out with reference to Turkish Financial Reporting Standards (TFRS), which are identical to international financial reporting standards (IFRS) in all companies regardless of their size or whether they are listed or not. The stated role of TFRS is to make accounting information more transparent for investors as well as for auditors to impede a potential indeterminacy that creates an opportunity for arbitrary interpretations.¹¹¹ The new provisions on auditing aim to present clear and understandable financial statements in accordance with the principles of disclosure to all related parties. To attract more foreign investors, it is essential to speak the language of international markets. Therefore, companies must prepare and disclose financial statements that foreign investors can understand. It is thought that these provisions would complement, in terms of both objectives and content, the auditing system under the Capital Markets Law. It can also be proposed that the new TCC would help non-listed companies during an initial public offering. Previously, the reporting systems of non-listed and listed companies were different from each other. This difference created problems for non-listed

¹⁰⁸ New TCC No.6102 (n. 23), Article 1527.

¹⁰⁹ Ibid Part 3, Articles 397-406.

¹¹⁰ The Preamble of Turkish Commercial Code Law No. 6102 (n. 101) Article 69.

¹¹¹ TFRS's novelty resided in the introduction of a different principle of accounting valuation. The new TCC completely changed the auditing procedure and revoked 'controller' system. Previously, the accounting departments of companies were responsible of auditing of financial tables. See New TCC No.6102 (n. 23), Articles 397-406, Article 437 and Article 514.

companies, when offering shares to the public, and was a source of additional costs for them. The use of the same system by all companies would facilitate the process of initial public offering. Furthermore, the use of international accounting standards in financial disclosure and auditing would oblige companies to become more transparent and reliable. Thus, it can be expected that the long-term effect of these provisions would increase the competitiveness and attractiveness of Turkish companies in foreign markets by providing a more transparent investment environment.

Pursuant to Article 340 of the new TCC, any deviation from the provisions concerning joint stock companies in the articles of association will only be possible if they are expressly allowed by the TCC.¹¹² Under the previous Code, all activities that were not prohibited by law could be stated in the articles of association. Article 340 is a key provision to that end. In contrast to the former TCC, which allowed freedom of contract, the new Code allows mandatory provisions principle.¹¹³ One of the purposes of the principle of mandatory provisions is to enforce a certain standard in the articles of association of companies, provide legal security, ensure openness and predictability and protect the interests of current and potential stakeholders.¹¹⁴ Confidence in capital markets would increase if, in particular, shareholders knew that they were entitled to certain minimum rights. As mentioned before, the new TCC aims to adopt the model of incorporation as a policy instead of family-controlled company models. Therefore, the mandatory provisions are obligatory for non-listed companies as well as listed companies. Even though corporate governance principles are an improvement in

¹¹² Ibid Article 340.

¹¹³ Rauf Karasu, '6102 Sayılı Türk Ticaret Kanunu'na Göre Anonim Şirketlerde Emredici Hükümler İlkesi' (Mandatory Provision in Joint-Stock Companies under the new Turkish Commercial Code) (2012) 18(2) Marmara Üniversitesi Hukuk Fakültesi Hukuk Araştırmaları Dergisi 311, 313-314 <<http://dosya.marmara.edu.tr/huk/fak%C3%BClteredergisi/2012C.18.S.2/7.oturum.pdf>> accessed on 26 June 2015

¹¹⁴ Ibid

protecting shareholder and stakeholder rights, they are not sufficient enough to completely eliminate the dominance of controlling shareholders in Turkish joint stock companies.

In addition, it is not possible to ensure fairness and provide protection to all shareholders unless the corporate governance principles are accompanied by mandatory provisions. Previously, most corporate governance related issues were regulated under the articles of association. However, this case posed obstacles to implement the corporate governance practices because the companies had the flexibility to differentiate their article of associations from the commercial code. This was in favour of controlling shareholders since they could be able to conceal misuse of their power. Mandatory provisions were a necessity to protect all shareholders' interests and to provide them fairness under Turkish law.

Conclusion

Well-functioning financial markets require strong foundations. A strong legal foundation has an effect on the development of a financial market and quality of investment. In weaker legal environments, equity investment in stock markets is less and firms obtain less external financing. This, in turn, affects economic growth.¹¹⁵

By reason of expanded liberalization of financial markets and financial integration as well as widened investment choices and mobilization of capital, attracting equity investment has become more important for most states than it used to be. Concomitantly, capital became separated from the principal. Therefore, monitoring the use of capital by a principal has become more complicated. Consequently, the need for corporate governance has arisen.

¹¹⁵ Stijn Claessens and Luc Laeven, 'Financial Development, Property Rights, and Growth' (2003) 58(6) *The Journal of Finance* 2401, 2402.

Corporate governance practices vary depending on the differences in business culture, corporate ownership forms and financing options. Ownership structure has an impact not only on the legal infrastructure but also on the nature of agency problems between shareholders and managers. As there are differences between dispersed and concentrated ownership, states where controlling shareholders dominate may require a different corporate governance framework compared to states dominated by widely-held companies.

What triggered the implementation of corporate governance principles in Turkey were the effects of the crises on its economy and business community. After the 1994, 1998 and 2001 economic crises, there emerged a need for rules that would increase flexibility and resistance to crises for all companies. Thus, the Capital Markets Board Corporate Governance Principles were introduced in 2003. Eventually, many aspects of corporate governance began to improve. However, there were still obstacles and challenges. One of the most challenging issues was that the state had an active role in shaping the framework of commercial law in Turkey until the 1980s. After the liberalization policy applied in 1980, this framework started to change and the state encouraged the market to find its own balance. Recently, the state has had a reduced role and now allows market participants to set the rules of the game. However, private enforcement of corporate governance has not been a successful way of influencing corporate behaviour because of the relatively weak power of non-controlling and institutional shareholders. The position taken in this chapter with regard to whether the regulatory role of the state is the problem or the solution in the Turkish corporate environment is that the state should use its power to interfere in a balanced way. The power should not shift too far towards the side of either the government or the market since the former would result in inflexible organization in response to the changing

conditions and the latter in lax regulation. The development of stock markets is strongly related to the quality of shareholders protection and property rights. However, the ownership structure of Turkish companies does not permit non-controlling shareholders to enjoy their rights properly. Regarding corporate governance, the regulatory role of the state should guarantee the minimum level of shareholder rights, fairness and transparency to the investors in the markets. This would result in a more reliable stock exchange and investment environment. For this reason, public enforcement is indispensable in Turkey. Taken together, it can be suggested that a balanced regulatory role of the state could attract more foreign investors as well as domestic investors to the stock exchange. Nevertheless, the corporate governance principles aim to guide the companies and increase their performance, encouraging them to be more competitive and capable of attracting external capital from the stock market. However, as mentioned above, this role should not extend beyond the point where the stock exchange is fully under the control of the state.

Family member dominance is common in the management of Turkish companies. The separation of ownership and control became a phenomenon in Turkish companies through the adoption of the modern public limited company structure. Lack of separation of ownership and control in real sense is one of the reasons that make the reform of corporate governance necessary under Turkish law in order to align it with the global context of stock market-based corporate governance systems. In Turkey, the problem is not about having insufficient rules but about the insufficient implementation of those rules because of the business culture.

As for its stock exchange, there was a tremendous economic and political instability in the first half of the 1990s. Both investors and companies became very sceptical about

the stock exchange. It was only after 2003 that a fairly stable environment was created. Meanwhile, in the rest of the world capital markets developed very quickly. Also, after the enactment of the Capital Markets Law a dual legal structure began in Turkey. The TCC continued as a framework law and the Capital Markets Law regulated the areas that were not covered by the TCC. This dual structure led to some points of conflict between the laws. As a result, both the Capital Markets Law and TCC proved inadequate. Therefore, Turkey had to catch up with the global development of capital markets and win investors back. To achieve this, the Turkish Parliament adopted the new TCC to redefine the rules of commercial life with a modern approach and to provide rules that will ensure the desired level of reliability, transparency and accountability.

In contrast to the previous TCC, the new Code has concretized the foundation principles of corporate governance. The philosophy of the new TCC is that the basic corporate governance principles should be applied to all companies even though it is a set of principles introduced for publicly-held companies with the aim of maintaining sustainable development.

Previously, compliance was purely voluntary and enforcement was left to internal corporate bodies and market forces, which did not work effectively in practice. The new TCC reformed most of the articles with a corporate governance approach. Many novelties, such as changes in the preparation of the balance sheets, transparency and professionalism of management were brought into the TCC. Even though the Capital Markets Board Corporate Governance Principles are still applies with a ‘comply or explain’, many of the Capital Markets Board Principles under the new TCC are mandatory and non-compliance will be sanctioned. It can be argued that enforcing corporate governance principles as mandatory rules to companies is against the ‘one

size fits all' approach. However, if the principles remained as guidelines only, the Turkish corporate cultural and the business ownership structure would not allow the efficient application of most of these principles. Therefore, even though enforcing corporate governance in a mandatory way in the TCC equates to state intervention in commercial life, the view taken here is that it is necessary in order to improve the environment for investment and generally doing business. According to the new TCC, all Borsa Istanbul companies are subject to mandatory application of Capital Markets Board Corporate Governance Principles.¹¹⁶ Previously, only BIST-30 companies¹¹⁷ were required to comply with certain principles on a compulsory basis and this can be considered as a big step forward for Turkey.

All corporate governance principles discussed above are not an end themselves but more a means to a greater end, namely a secure and transparent environment. In Turkey, in order to spread the capital to the grassroots, the law should be not only designed to provide company owners with the right incentives to seek external funding but also sound enough to inspire investors to invest in the equity market.

An important problem that can be seen in the context of corporate governance is the adoption of principles imported from other states. The adoption of the OECD Corporate Governance Principles engendered compliance problems in Turkish commercial law. These Principles, which seek to embed the shareholder oriented model, are widely accepted around the world. Even though the principles purport to allow different implementations, one can argue that they in fact promote an Anglo-American model of corporate governance, which is characterised by dispersed

¹¹⁶ Excluding companies listed on Emerging Markets and Watchlist Market.

¹¹⁷ Excluding banks.

ownership and focuses on 'shareholder value'.¹¹⁸ In practice, there were problems in the implementation of some concepts, such as independent non-executive directors and equal treatment of shareholders. For instance, as a result of the ownership structure, the views or assessments of independent members of the BoD has the increased likelihood of contradicting the power of the majority shareholders of the company.

In addition, the existing business culture was not really compatible with corporate governance principles based on values and practices of another state. On the other hand, non-compliance with widely accepted principles sends a message to the international financial community that the investment environment is not reliable. Any company, which deviates from the norm, is placed at a disadvantage when competing for foreign investors. Therefore, even though compliance with the OECD principles was voluntary, it was in fact necessary to attract investment. For this reason, the new TCC adopted principles similar to the OECD Corporate Governance Principles and aimed to change the family-owned company structures of Turkish joint stock companies into corporations.

From the above analysis, it can be argued that Turkish companies have had a number of problems in implementing corporate governance principles like in most developing states. However, these problems have not occurred because of a delay in the development of the legal framework, but because of the mentality of Turkish companies and the corporate culture that the new TCC strives to change.

¹¹⁸ Paddy Ireland and Renginee G. Pillay, 'Corporate Social Responsibility in a Neoliberal Age' in Peter Utting and José Carlos Marques (eds.) *Corporate Social Responsibility and Regulatory Governance Towards Inclusive Development?* (Palgrave Macmillan, 2010), 91.

Chapter 4

THE IMPACT OF CORPORATE GOVERNANCE ON THE INFLUX OF FOREIGN EQUITY CAPITAL INTO TURKEY

Introduction

In the Turkish economy, the influx of foreign capital is one of the primary drivers of growth in GDP. This is due to the inadequacy of domestic savings.¹ To date, the greater part of the available domestic savings has been directed towards investment instruments other than the stock market due to reasons related to the political environment, economic uncertainty and chronically high inflation. These factors have converged to lower investor confidence in equity markets.

Previous regulations have proved inadequate for establishing a reliable, credible, accountable and transparent regulatory environment for investment, and one which was able to protect and safeguard the rights of investors. As a result, businesses in Turkey have suffered from lack of transparency.² Turkish companies need to increase their transparency and accountability levels to access foreign capital. Therefore, the creation of a modern commercial code became essential, so that Turkey could update and modernise its regulatory framework and keep up with the economic developments of highly competitive and differentiated markets. The new TCC was designed to strengthen corporate governance procedures and to embed these new principles within the wider Turkish business culture.³

¹ See Chapter 1 Section 5 pg. 41

² See Chapter 2 Section 3 pg. 75 and Chapter 3 Section 2 pg. 112

³ Cüneyt Yüksel, 'Recent Developments of Corporate Governance in the Global Economy and the New Turkish Commercial Draft Law Reforms' (2008) 3(2) Journal of International Commercial Law and Technology 101, 106-107.

This chapter will investigate the relationship between corporate governance and foreign equity investment to determine whether or not corporate governance has been a factor in attracting foreign investors into the Turkish capital market. Evidence from the Turkish Investor Relations Association and Central Registry Agency⁴ will be presented to support the contention that it has been a determining factor.

Table 1 Number of Foreign Equity Investors in Borsa Istanbul Corporate Governance Index (BIST-CGI)

Year	Number of Foreign Equity Investors in BIST-CGI	Increase in Numbers	Number of Foreign Equity Investors in BIST	Percentage of Number of Foreign Equity Investors
December 2010	3582	-	7,523	47%
December 2011	3969	387	7,646	51%
May 2012	4014	45	7,863	51%
December 2012	4431	417	8,222	53%
December 2013	4771	340	9,451	50%

Source: See Appendix 1⁵

⁴ The Report has been prepared by The Turkish Investor Relations Association and the Central Registry Agency (CRA), using CRA's database. See <https://www.mkk.com.tr/wps/portal/MKKEN/InformationCenter/ExchangeTrendsReport> accessed on 26 June 2015 for full reports.

⁵ In Table 1, there are two rows showing the number of investors, separately for May and December for 2012. This happens because the provisions of new TCC on corporate governance entered into force on July 01, 2012 so the quarterly Exchange Trends Report in May 2012 is the last data showing the number of foreign investors before the enactment of TCC. The data on May 2012 divides the available data into two equal periods, eighteen months before and after the enactment of TCC.

At the end of 2013, the number of publicly-traded companies in Borsa Istanbul was 356.⁶ 47 of these companies, accounting for 13% of all listed companies, were registered in the BIST-Corporate Governance Index. In general, companies included in the BIST-Corporate Governance Index are in a better position than other Borsa Istanbul listed companies to receive foreign investment. Table 1 aggregates the data on the number of foreign investors transacting in the BIST-Corporate Governance Index by year. The table shows that roughly half of all foreign investors in Borsa Istanbul preferred to invest in companies listed in the BIST-Corporate Governance Index. Even though all Borsa Istanbul companies have to embrace the ‘comply or explain’ principle, companies listed in the BIST-Corporate Governance Index have to meet a corporate governance rating threshold which is determined by the rating institutions incorporated by the CMB.⁷ The high percentage of foreign investors in the BIST-Corporate Governance Index shows that these investors value companies that place an emphasis on corporate governance. A possible explanation for this high percentage is that in a market where information on the governance practices of companies is scarce, companies listed in the corporate governance index are more attractive to foreign investors because they have more access to appropriate and credible information. Emphasis on corporate governance and increased compliance is likely to reduce information asymmetry as investors will be able to gain more credible information about the companies they wish to invest in. This, in turn, will reduce agency costs. In addition, companies that engage in good corporate governance

⁶ Central Registry Agency, BIST Trends Report 2013, 5, https://www.mkk.com.tr/wps/wcm/connect/f705c93a-3627-4c50-9254-bceab1a71cea/BIST_Trends_Report_VII.pdf?MOD=AJPERES accessed on 8 June 2015.

⁷ BIST-Corporate Governance Index aims to measure the price and return performances of companies traded on Borsa Istanbul Markets (except companies in Watch list Companies Market and List C) with a corporate governance rating of minimum 7 over 10 as a whole and minimum of 6.5 for each main section.

practices outperform those that do not.⁸ Investors in the BIST-Corporate Governance Index profit more compared to those that invest in the BIST-100.⁹ This is another explanation for the preference that foreign investors show for BIST-Corporate Governance Index companies. As Table 1 indicates, companies in the BIST-Corporate Governance Index can differentiate themselves in the market and are more attractive to foreign capital. The evidence suggests that corporate governance plays a key role in attracting foreign investors to the Turkish capital market.

Foreign investors recognise the importance of corporate governance in their investment decisions because of the difficulties in gathering the necessary information. Corporate governance can bridge the information gap and become a useful tool for attracting foreign investment. At the end of 2013, foreign investors, which account for 0.86% of the total investors in Turkey, hold 63% of the market value of the stocks of Borsa Istanbul.¹⁰ Policy-makers should bear in mind the importance of foreign capital for Turkey and focus on increasing transparency and accountability. This would reduce the investment risk to foreign investors and attract more foreign investors to the Turkish capital market. In this context, the provisions of the new TCC aim to establish a corporate governance framework that would strengthen corporate governance raise the standards, and increase transparency and accountability in the Turkish market.

⁸ Osman Gürbüz, Aslı Aybars and Özlem Kutlu, 'Corporate Governance and Financial Performance with a Perspective on Institutional Ownership: Empirical Evidence from Turkey' (2010) 8(2) Journal of Applied Management Accounting Research 21, 26.

⁹ See Chapter 3 Section 1.3 pg. 107

¹⁰ Foreign investor share in market capitalization was 62% as of the end of 2011, 66% as of the end of 2012. The Turkish Investor Relations Association and Central Registry, BIST Trends Report 20 January 2014, https://www.mkk.com.tr/wps/wcm/connect/f705c93a-3627-4c50-9254-bceab1a71cea/BIST_Trends_Report_VII.pdf?MOD=AJPERES accessed 10 June 2015.

Table 2 Number of Foreign Equity Investors in BIST by Year

YEAR	Number of Foreign Equity Investors	Increase in Numbers	Increase in Percentage	Percentage of Number of Foreign Equity Investors
December 2010	7,523	-	-	0.68%
December 2011	7,646	123	1.63%	0.70%
May 2012	7,863	217	2.8%	0.71%
December 2012	8,222	359	4.3%	0.76%
December 2013	9,451	1229	14.9%	0.86%

Source: Central Registry Agency

The data in Table 2 suggest that in general the number of foreign investors in Borsa Istanbul has increased over the last four years. More specifically, the analysis of the change in the number of foreign investors between 2010 and May 2012 as well as between May 2012 and December 2013 can be used to determine whether the TCC has been successful in attracting foreign investors. A significant increase in the number of foreign investors can be seen between these two periods when compared with the period before the enactment of the new TCC when the total increase in the number of foreign investors was 340. After its enactment, the number went as high as 1588. In other words, since the introduction of the new TCC, Borsa Istanbul has experienced a 20% increase in the number of foreign investors, while the percentage of increase was 4.5% from December 2010 to May 2012.

The subsequent sections will discuss the five-fold increase that occurred after the enactment of the TCC, and how this illustrates that the TCC, despite its flaws, has had a positive effect on the number of foreign investors investing in the Turkish capital market. This is where the notion of investor perception becomes important. Turkey would achieve a higher growth rate if it could improve the perception among foreign investors about the potential risks associated with investing in an economy like Turkey. Research has shown that transparent and accountable disclosure regimes can increase investor confidence.¹¹ Most of the corporate governance regulations in the TCC aim at increasing transparency and accountability of companies. The increase in the number of foreign investors shown in Table 2 can be interpreted as being due to an improvement in the perception of foreign investors. If this increase can be attributed to the enactment of the TCC, it can be suggested that the establishment of a regime based on disclosure, transparency and accountability has a positive impact on the investors' perception and can significantly reduce investment risks.

The next section will attempt to examine the main reasons of having low transparency and accountability in Turkish business culture. Later, it will go on to the TCC provisions that have contributed towards the increase of transparency and accountability, and have had a positive effect on the attractiveness of the Turkish capital market. The rest of the chapter supports the idea that corporate governance is a determining factor in attracting foreign investors into Turkey. Even though there is much room for improvement and there are still challenges to be faced, the new TCC has improved the regulatory framework for corporate governance in Turkey.

¹¹ See Chapter 1 Section 6 pg. 46

1. The impact of corporate governance principles on Turkish corporate culture

1.1 The culture of transparency in Turkey

The starting point is that Turkey needs to attract external financing to sustain its growth, because it cannot accumulate the required level of savings domestically. Previous research has attempted to explain the ability of companies in various states, including Turkey, to raise external funds in the form of either equity or debt. GDP was as a control variable in their regressions. Their results indicate that, while GDP growth was high in Turkey, access to external capital was low.¹² The ability of Turkey to attract foreign equity investment has always been limited. The Turkish economy has shown remarkable performance in the recent years and has been one of the fastest growing economies in the world.¹³ However, as Table 2 shows, the number of foreign investors does not even account for 1% of all investors in Borsa Istanbul. The low percentage of foreign investors illustrates that the economic growth alone is not attractive enough for foreign investors. The observed increase in the number of the foreign investors after the enactment of TCC signals that foreign investors have welcomed the attempts of the Turkish government to improve the legal framework and strengthen the investment environment.

Equity investment is a contract, as discussed earlier.¹⁴ Contracting parties need information on the companies' capability to meet the terms of the contract. To the extent that the investors do not have adequate access to company specific information to make informed decisions, there is a higher demand for transparency in order to

¹² See Table 2 and Table 8 in Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer and Robert W. Vishny, 'Legal Determinants of External Finance' (1997) 52(3) *The Journal of Finance* 1131, 1138,1147.

¹³ OECD, http://stats.oecd.org/index.aspx?DataSetCode=EO92_INTERNET accessed on 01 July 2015

¹⁴ See Chapter 1 Section 2 pg. 26

protect their rights.¹⁵ Therefore, the level of transparency and quality of disclosure affect the level of investment that companies can attract. Evidence suggests that companies that are famed for their transparency reap the benefits of increased investments by shareholders.¹⁶

Transparency and full disclosure is of vital importance for Turkey, where foreign capital attracted by equity investment is necessary to sustain its growth rate. Despite the incentives for disclosing information, the level of transparency in Turkish firms has always been low.¹⁷ The organisational structure in a society, including the legal system and business groups, is the result of its political system. Political process shapes financial architecture by designing and enforcing legislation that affects the structure of capital markets and companies in a way that reflects the dominant political principles prevailing in its society.¹⁸ Such legislation affects the allocation of power among companies' shareholders and stakeholders, which in turn shape the operation of corporate governance systems.¹⁹ For instance, some states favour diffused ownership of companies, whereas others favour concentrated.²⁰ Such different regulatory policies shape the expectations of the investors that guide the allocation of sources. To the extent that the relevant legislation reflects the underlying corporate culture, it can be argued that the politics is a factor that influences the way companies are run, their primary objectives, their level of dependence on external

¹⁵ Robert M. Bushman, Joseph D. Piotroski and Abbie J. Smith, 'What Determines Corporate Transparency?' (2004) 42(2) *Journal of Accounting Research* 207, 220.

¹⁶ Gretchen R. Vogelgesang and Paul B. Lester, 'Transparency: How Leaders Can Get Results by Laying it on the Line' (2009) 38(4) *Organizational Dynamics* 252, 252.

¹⁷ Mine Aksu and Arman Kösedag, 'Transparency and Disclosure Scores and their Determinants in the Istanbul Stock Exchange' (2006) 14(4) *Corporate Governance: An International Review* 277, 279.

¹⁸ Janet Dine and Marios Koutsias, *The Nature of Corporate Governance The Significance of National Cultural Identity* (Edward Elgar 2013), 64.

¹⁹ Marco Pagano and Paolo Volpin, 'The Political Economy of Finance' (2001) 17(4) *Oxford Review of Economic Policy* 502, 506.

²⁰ See Mark J. Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2000) 53(3) *Stanford Law Review* 539, who provides a political explanation for the differences in ownership structures of companies in different states.

financing and corporate transparency through government policies. Companies are the outcomes of a political process. Therefore, the patterns of corporate transparency are reflections of the political process of the states within which they operate. This observation is consistent with the situation in Turkey that, to a large extent, as Turkey has had a poor culture of transparency due to its political and legal infrastructure.

To promote economic development, the State interfered to the economy during the early periods of the Republic. Deployed state intervention had serious effect on the Turkish economy ranging from the prohibition of transactions in foreign currency to ownership structure of companies. This has clearly influenced the transparency and disclosure philosophy in the Turkish business culture. As a result of this protectionist attitude of the State to foreign investment, it did not play a significant role in Turkish economy until the late 1980s when Turkey switched to a liberal economy.²¹ Interventionist ideology has shaped the foreign investment policy over the course of the Republican history. Furthermore, the protectionist approach towards foreign equity investment resulted in closing down Borsa Istanbul due to volatility in exchange rates and reopening it several times before 1986.²² This shows that the government viewed the stock exchange as a currency market and ignored its security trading role. The exchange control, which brought foreign equity investment influx to an end, created an environment that had a negative effect on the progress of foreign investment regulatory framework. The findings observed in this Thesis mirror that, as the activities of foreign investors were largely restricted, the need for legislation to ensure investors a reliable investment environment which would provide them transparency and protection did not arise until the early 1990s.

²¹ See Chapter 1 Section 3 pg. 33

²² Ibid.

State intervention affected not only the economic policy as an important factor that significantly influenced the nature of transparency. The relative strength of the State in structuring the private sector at the early periods of the industrialization process created a very important role in shaping the transparency culture in companies and related legislation in Turkey. The state-business relations resulted in non-transparent links between the state and capital owners. This resulted in highly concentrated family ownership.²³ These links prohibited the delegation of control to professional managers. Business groups became the typical large business form and companies established themselves as holding companies in Turkey. However, the previous TCC did not develop any special rules or regulations for corporate groups in respect of their legal position. In most of these businesses, family members are insiders, who keep the majority control of the company and hold key managerial positions in the central management unit and the affiliated companies. Controlling insiders, who are active in management, had credible and adequate information about the company. As a consequent of being family controlled companies, the demand for transparency rules and financial reporting to reduce information asymmetry became low in Turkish companies. In family controlled companies, detailed and periodic reports were not prepared unless there was a dispute between shareholders.²⁴ The high concentration of ownership reduced the need for higher transparency. Additionally, when the previous TCC was enacted, almost 60 years ago, the needs of Turkish economy and commerce were different. There was not a regulated stock exchange in Turkey and thus there was

²³ See Chapter 2 Section 3.1 pg. 75

²⁴ Hasan Pulaşlı, 'Elektronik Ortamda Anonim Şirket Genel Kuruluna İlişkin Düzenlemelerin Evrimi ve 6102 Sayılı Türk Ticaret Kanunundaki Durumu' (Evolution of the Regulations Relating to the General Assembly in Electronic Media and Their Status in the Turkish Commercial Code No.6102) Elektronik Nehir Dergi Halil Arslanlı Bilim Arşivi, 12,<<http://arslanlibilimarsivi.com/sites/default/files/makale/HasanPulasli-internetOrtamindaGenelKurul.pdf>> accessed on 26 June 2015.

not a pressing need for distribution of information. Therefore, the previous TCC did not include any mandatory provisions regarding accounting principles and financial statements. Joint-stock companies were internally audited. Auditing was performed by controllers in joint stock companies. The controllers were not required to possess any accounting expertise. Their role was to approve the reports prepared by the employees of the companies without performing any physical auditing.²⁵ The accounting system enabled the transfer of profit and assets among companies within the same holding group in the absence of any rules preventing corporations from handling such transactions. The regulatory bodies did not need to ensure transparency by closing loopholes and by ensuring better enforcement of accounting standards. The absence of regulation and inadequate enforcement has been the real problem in the Turkish business culture that has led to poor transparency practices. Evidently, the State intervention and its overall regulatory approach became an impediment to attracting foreign investment.

There is no doubt that the cultural development processes of societies generate a unique configuration of economic systems within which business life and management practices, such as the degree of tolerance of inappropriate behaviour and flexibility to professional development, are developed.²⁶ In 1980, one of the well-known cultural studies in business management stated that Turkish business culture profile inclines to accept less flexibility to professional management.²⁷ One can argue that in an economy, where regular stock exchange does not yet exist, residing the

²⁵ Koray Tuan and Emrah Arıoğlu, 'The State of Independent Auditing in the Turkish Commercial Code' (2014) 1(1) *Journal of Economics, Finance and Accounting* 46, 51.

²⁶ John Kuada and Hans Gullestrup, 'The Cultural Context of Corporate Governance, Performance Pressures, and Accountability' in Istemi S. Demirağ (ed.), *Corporate Governance, Accountability and Pressures to Perform an International Study* (Jai Press, 1998) 26.

²⁷ Geert Hofstede, *Culture's Consequences: International Differences in Work Related Values* (Sage Publications, 1980), 336.

family members with professional managers is not likely to become an issue of debate, because family members are the ultimate beneficiaries. As controlling shareholders, family members tend to get business decisions that will benefit them and they would possibly be unwilling to adopt any of the measures professional managers recommend. Consequently, in order not to lose their power and authority in the company, they would object to having professional management. Thirty two years later, there has been little change to this culture. It became the case that the family controlled companies constitute a large percentage of the stock market and they maintain a controlling position by a pyramidal ownership structure.²⁸ According to the findings of an OECD survey at the end of 2012, only 16% of the firms had a free float ratio above 50%, while among the 20 largest companies in terms of market capitalisation, none of them had a free float ratio above 50%.²⁹ The strong presence of family control has remained dominant even in listed companies, despite the developments in capital markets and investment.

The extent of expropriation problems faced by foreign investors plays a central role in attracting foreign investment. Evidence presents that one of the major obstructions to foreign equity investing is the limited information on stock markets.³⁰ It is often argued that foreign investors are at an informational disadvantage relative to local investors.³¹ They are less comfortable due to the complexity of the foreign environment associated with differences in culture, language, political, and regulatory

²⁸ See Chapter 2 Section 3 pg. 75

²⁹ See OECD Corporate Governance Supervision and Enforcement in Corporate Governance (2013) Table 3.1, 71, <http://www.oecd.org/daf/ca/SupervisionandEnforcementinCorporateGovernance2013.pdf> accessed on 21 June 2015.

³⁰ Sudarshan Gooptu, 'Portfolio Investment Flows to Emerging Markets' (1993) International Economics Department The World Bank Policy Research Working Paper WPS 1117, 27.

³¹ See Michael J. Brennan and H. Henry Cao, 'International Portfolio Investment Flows' (1997) 52(5) *The Journal of Finance* 1851-1880 and Hyuk Choe, Bong-Chan Kho, Rene M. Stulz, 'Do Domestic Investors Have an Edge? The Trading Experience of Foreign Investors in Korea' (2005) 18(3) *The Review of Financial Studies* 795-830.

background, and limited human networks.³² Consequently, the extent of information disclosed by the companies becomes significant. Consistent with this idea, foreign investors shy away from companies where the extent and quality of disclosed information is low. Transparency and disclosure practices mitigate agency problems and protect the rights of investors from the possible expropriation of insiders based on their superior information.³³ This suggests that improving a company's transparency can be expected to lead to an increase in foreign investment influxes.

In relation to stock exchange regulations in Turkey, it would not be an exaggeration to argue that it resembles a patchwork of rules. Investors have fairly extensive legal rights. However, in practice, their ability to exercise them could be restricted by corporate practices or articles of associations. Therefore, they could not reach a sufficient level of efficiency. For instance, the Listing Rules of the Stock Market require certain standards of disclosure and transparency, but the accounting practices were not compatible with these standards. Listed companies started to report their financial statements according to IFRS after 20 years from the establishment of the stock exchange. It was only in 2013 that this became a legal requirement under the new TCC. As non-listed companies were not required to comply with IFRS, groups of companies could still be able to transfer profits and assets among companies under the same holding group. Investors were misled as a result of the absence of consolidation accounting.³⁴ Opaque and unreliable financial reports resulted in costly-to-obtain information. The patched regulations have produced a dualism in the legal system, under which the TCC remains as the framework law, whereas Capital Markets Law

³² Byung S. Min and Robert G. Bowman, 'Corporate governance, Regulation and Foreign Equity Ownership: Lessons from Korea' (2015) 47 *Economic Modelling* 145, 147.

³³ Sandeep A. Patel, Amra Balic, Liliane Bwakira, 'Measuring Transparency and Disclosure at Firm-Level in Emerging Markets' (2002) 3 *Emerging Market Review* 326, 328.

³⁴ Aksu and Köse dağ (n. 17) 280.

makes up the deficiencies of TCC. In the long run, both laws proved insufficient to satisfy the transparency requirements of the investors. Instead of a patchwork of regulations, the existing regulatory framework should have been revised in order to form a legal framework with clear and effective rules to promote legal certainty, effective monitoring and transparency.

The lack of transparency prevailing in the market can breed a culture, where aligning the interests of principals and agents, is not considered a priority. This background was not so favourable for foreign investors. The lack of disclosure and transparency philosophy justifies the difficulty of Turkish companies to attract foreign equity investment. In today's business world, transparency has become a necessity.³⁵ Transparency became a fundamental issue with which lawmakers should closely deal and in which the companies should make progress.

1.2 Corporate transparency after the Capital Markets Board Corporate Governance Principles

The aforementioned environment started to change as a result of the changes in Turkish politics, economic reforms, reforms and new regulations on the financial reporting environment. Even though the improvements in the political and economic environment, there were still significant indicators suggesting that Turkey is facing an investor confidence problem. Turkey was ranked as the fourth least transparent state in the world in Opacity Index in 2001.³⁶ Again, in a survey, which covers 188

³⁵ Fiammetta Borgia, 'Corporate Governance & Transparency, Role of Disclosure: How Prevent New Financial Scandals and Crime?' (2005) Transnational Crime and Corruption Centre, Research Paper 20

³⁶ See PriceWaterHouseCoopers, The Opacity Index 2001, Exhibit 1, 5 < <http://people.stern.nyu.edu/adamodar/pdfiles/articles/opacity.pdf>> accessed on 26 June 2015.

companies from six emerging markets, Turkey got the lowest score in transparency and second lowest in shareholders' rights.³⁷

Investors' perception on transparency helps attracting capital inflows.³⁸ Corporate governance has become increasingly important for improving investors' confidence. The CMB of Turkey requires listed companies to comply with the corporate governance principles since 2003, but compliance with Capital Markets Board Principles is not among the listing requirements for Borsa Istanbul.³⁹ However, in order to encourage listed companies to comply with the principles, Borsa Istanbul and the CMB have joined forces to set up a Corporate Governance Index, as discussed in the previous chapter.⁴⁰ This index was expected to act as an incentive for better corporate governance for listed companies. When the implementation of corporate governance principles in Turkey was evaluated, it was found that only 48 of all listed companies have a corporate governance rating of 7 or more at the end of 2014.⁴¹ The number of listed companies in this index shows that the efforts to promote better corporate governance among listed companies have failed to thrive. The lack of Borsa Istanbul listed companies' interest in being listed in this index is interpreted as that companies are not so eager about the implementation of these principles, because corporate governance principles were seen as an additional burden for most companies. The findings of this Thesis show that the requirement to comply with the above corporate governance principles did not come from potential investors, but from

³⁷ Roberto Newell and Gregory Wilson, 'A Premium for Good Governance' (2002) 3 McKinsey Quarterly Exhibit 20, 22.

³⁸ Niranjana Chipalkatti, Quan V. Le, and Meenakshi Rishi, 'Portfolio Flows to Emerging Capital Markets: Do Corporate Transparency and Public Governance Matter?' (2007) 112(2) Business and Society Review 227, 244.

³⁹ Capital Market Board of Turkey, Istanbul Stock Exchange Listing Regulation Official Gazette Number: 25502 (24 June 2004)

⁴⁰ See Chapter 3 Section 1.3 pg. 107

⁴¹ Corporate Governance Association of Turkey, <http://www.tkyd.org.tr/faaliyetler-kurumsal-yonetim-endeksi-tum-firmalar.html> accessed on 15 June 2015.

external sources, such as the IMF and the EU.⁴² Only companies, which directly target foreign investors, became interested in being listed in this index.⁴³ The lack of demand for corporate governance implementation from investors explains the relatively poor interest of companies to be listed in this index. Additionally, the government neither hindered nor completely supported the efforts of the CMB in strengthening the legal foundation and providing sufficient incentives for companies to be listed in the corporate governance index. For these reasons, companies, except for the largest and most liquid ones, did not have sufficient motivation for being listed in the index.

The inclusion of a company into the Corporate Governance Index is an indicator of the fact that this company has adopted good corporate governance practices.⁴⁴ As Table 1 shows, foreign investors primarily prefer such companies when forming their portfolios. This confirms that investors value not only clear, accurate and comparable information in due time but are also interested in whether the companies to which they direct their capital are managed well. Graph 1 shows one of the most interesting findings of this research. The graph shows the annual increase in the number of foreign investors in BIST and the number of listed companies in the BIST-Corporate Governance Index during the four year period. From the data in Graph, it is apparent that there is positive correlation between the number of companies listed in the index and the number of foreign investors. Borsa Istanbul has experienced a parallel

⁴² See Chapter 3 Section 1.2 pg. 100 for discussion

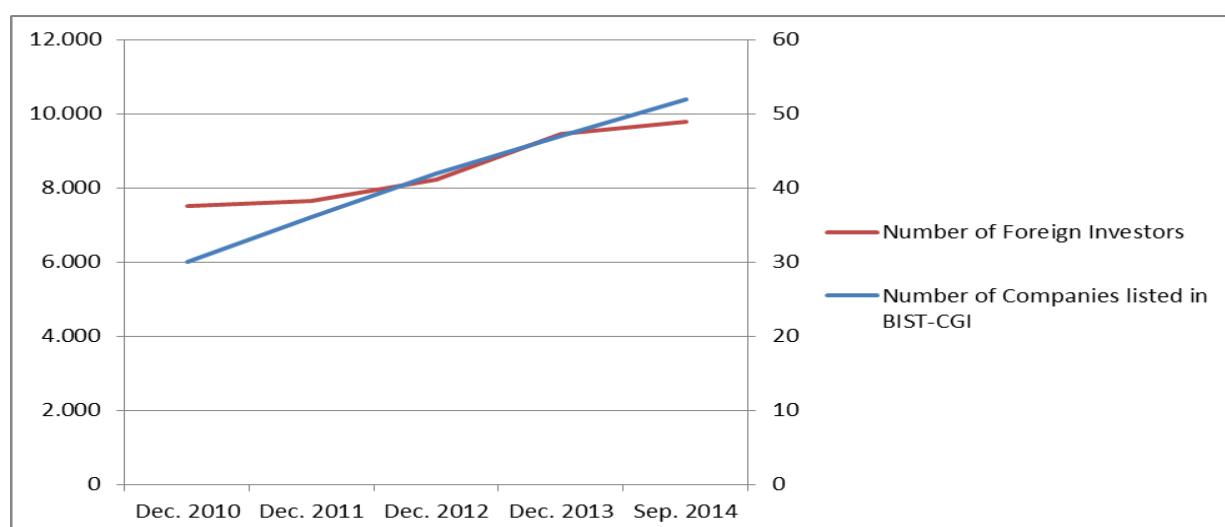
⁴³ Melsa Ararat and Burçin Yurtoğlu, 'Rating-Based Indexing of the Istanbul Stock Exchange: Lesson's from Novo Mercado's Success to Advance Corporate Governance Reforms' in Novo Mercado and Its Followers: Case Studies in Corporate Governance Reform, Global Corporate Governance Forum Focus 5 (2008), 67,

<http://www.ifc.org/wps/wcm/connect/e1162a8048a7e69ea787e76060ad5911/Novo%2BMercado%2Btext%2Bscreen%2B4-21-08.pdf?MOD=AJPERES>, accessed on 28 June 2015.

⁴⁴ Ozlem I. Koc, 'A Research On Relationship Between Corporate Governance Ratings Of Banks Listed in BIST Corporate Governance Index and Some of Their Characteristics' (2014) 8 Journal of International Scientific Publications-Economy and Business 183, 190.

increase in the number of companies listed in corporate governance index and the number of foreign investors. This means that the higher the number of companies listed in the corporate governance index, the higher the possibility to attract foreign investors to Borsa Istanbul. Therefore, increasing the number and free float rate of companies listed in this index is important for attracting foreign investors. Thus, it is important to increase the quality of corporate governance to make companies get listed in this index.

Figure 1 Relation between the Number of Listed Companies in the BIST-Corporate Governance Index and the Number of Foreign Investors



Source: See Appendix 1

The CMB followed a soft law approach, which is characterised by a voluntary implementation of the code and mandatory disclosure of compliance. The corporate governance activities were not underpinned by legislation. The advantage of the ‘comply or explain’ approach lies in its flexibility.⁴⁵ Companies can decide

⁴⁵ Sridhar Arcot and Valentina Bruno, ‘One Size Does Not Fit All, After All: Evidence from Corporate Governance’ (2007) accessible at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=887947> 4, 26 accessed on 25 June 2015 and for a broad discussion, see also Marc T. Moore, “Whispering Sweet Nothings”: The Limitations of Informal Conformance in UK Corporate Governance’ (2009) 9(1) Journal of Corporate Law Studies 101.

individually to adopt corporate governance practices according to their specific situations.⁴⁶ In the Turkish corporate culture, the ‘comply or explain’ approach has an obvious setback. Companies are allowed to decide not to implement particular principles found in the code, provided they disclose some sort of explanation. Companies often tend to explain non-compliance taking the advantage of the weak corporate governance enforcement and absence of a method to verify the accuracy of the explanations. For instance, in some reports, non-compliance is explained by stating that it is not mandatory to comply with certain principles.⁴⁷ Two years after the issuance of the principles, the CMB required listed companies to include a ‘Corporate Governance Compliance Report’ in their annual reports. In spite of the fact that there were more than 100 provisions, some of the reports composed of only a few pages which were kept almost identical in the following years.⁴⁸ This shows that neither the requirement of compliance nor the explanation was fulfilled properly. As it becomes apparent, the potential for abuse was a real possibility.

Even though there were significant improvements in the regulatory framework concerning corporate governance, voluntary enforcement did not help in the implementation of the reforms. This is exemplified in the research undertaken by Standards and Poor’s, where it was demonstrated that the CMB principles of corporate governance on disclosure had little effect on the disclosure practices of companies until the introduction of mandatory compliance reporting and the main improvements

⁴⁶ Miroslov Nedelchev, ‘Good Practices in Corporate Governance: One-Size-Fits-All vs. Comply-or-Explain’ (2013) 4(6) International Journal of Business Administration 75, 77.

⁴⁷ Melsa Ararat and Burçin Yurtoğlu, ‘Sermaye Piyasası Kurulu’nun ‘Kurumsal Yönetim’ Konulu Tebliği ile İlgili Genel Değerlendirme Ve Yorum’ (An Assessment of the Recent Legal Reforms Concerning ‘Corporate Governance’ Introduced by the Capital Market Boards of Turkey) (2012), 5, <http://ssrn.com/abstract=2040376> accessed on 25 June 2015

⁴⁸ Melsa Ararat, ‘“Comply or Explain” Without Consequences; The Case of Turkey’ (2010), 2, <http://ssrn.com/abstract=1599831> accessed on 25 June 2015.

came with the mandatory implementation of IFRS.⁴⁹ These results provide further support for that Turkish companies comply with corporate governance principles only if there are legal sanctions.

Additionally, the dualism in the legal system resulted in different practices of law in companies. The stock market regulations, created by Capital Markets Law, covered listed companies only, which account for less than 1% of companies in Turkey. Non-listed companies did not have the obligation to comply with these regulations. According to the findings of the abovementioned research, there was a difference between the disclosure level of holding companies and their non-listed affiliates.⁵⁰ This finding also supports that the patchwork regulations could not be effective enough to eliminate concerns about the transparency of business groups. With the operation of the 'comply or explain' approach, Turkish companies did not have any strong motivation or incentive to improve their transparency practices. Despite the fact that Turkey has improved its legal framework, much has remained the same in terms of the transparency culture of companies due to the limited implementation of the CMB principles by companies and the insufficiency of the adopted enforcement approach.

Corporate governance principles would lose their flexibility, adaptability and effectiveness, if they become hard law.⁵¹ To encourage companies to adopt the spirit of the corporate governance principles, mandatory compliance is not the solution, as one size does not fit all. Therefore, a fully statutory approach should also be avoided.

⁴⁹ Melsa Ararat and Amra Balic, 'Turkish Transparency and Disclosure Survey 2008: A Year of Little or No Progress' (2008), 3, http://research.sabanciuniv.edu/9553/1/Official_report2008.pdf accessed on 27 June 2015.

⁵⁰ Ibid 4.

⁵¹ Eddy Wymeersch, 'How Can Corporate Governance Codes be Implemented' in Guido Ferrarini and Eddy Wymeersch *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (OUP, 2006), 157.

The State aimed to increase transparency and accountability of companies by widespread use of corporate governance principles and voluntary enforcement in order to provide a more reliable and transparent investment environment. However, the ‘comply or explain’ approach did not succeed in aligning the regulatory goals and the business culture of Turkish companies. This enforcement approach facilitated the creation of a system, which conferred on corporations a degree of immunity from the consequences of incomplete reports. However, it was overlooked that the publication of incomplete information and sporadic compliance are likely to severely damage investors’ trust. The ‘comply or explain’ enforcement approach needs to be changed because so far it does not seem to be successful or suitable to bring transparency into the Turkish corporate culture. The limited number of foreign investors in Borsa Istanbul highlights the need for a strong corporate governance regulation with effective implementation and enforcement. The level of transparency and accountability will not be improved unless the problem of compliance and enforcement in Turkish corporate governance is not addressed.

2. Transparency under the new TCC

Turkey is still in the process of improving the legal structure of its capital market. Deficiencies in the legal framework and regulatory approach contribute significantly to the risks of investing in the Turkish equity market. On the question of the previously applied corporate governance regulations of Turkey, the CMB reported that there existed various imperfections in the regulations related to shareholders rights.⁵² Investors were unable to exercise their rights effectively as well as to communicate and interact effectively with management. Principles have been adopted

⁵² Capital Markets Board of Turkey Corporate Governance Principles <http://www.spk.gov.tr/displayfile.aspx?action=displayfile&pageid=55&fn=55.pdf> 10, accessed on 25 June 2015

and incorporated in the articles of association in order to improve and protect shareholders rights. However, according to the obsolete TCC activities which have not been forbidden by the law could be stated in the articles of association.⁵³ Articles of association became a means to increase the power of controlling shareholders because it became possible to eliminate the provisions that make them less effective.

Attempts have been made in recent years to extend the concept of transparency to cover a wider range of corporate activities in Turkey. The latest regulation that deals with improving transparency and disclosure is the new TCC. The enactment of the new TCC has contributed to an increase in the implementation of corporate governance principles in companies in Turkey, as it has established a new status quo within which the basic corporate governance principles have been concretised.⁵⁴

The starting point for corporate governance under the new TCC is the improvement and protection of investor rights. While the new TCC has established provisions that define the corporate governance mentality, as discussed in the previous chapter, it has also brought in regulations that comply with the basic principles, such as transparency and accountability. For the purpose of attracting foreign investors, creating an effective information system is a priority among the aforementioned regulations. The new TCC envisions transparency and disclosure practices as a system that has evolved to reduce agency problems and increase the attractiveness of Turkish companies. Thus, it has put in place transparency and disclosure practices to protect investors from the possible expropriation of insiders due to their superior information and to

⁵³ Rauf Karasu, '6102 Sayılı Türk Ticaret Kanunu'na Göre Anonim Şirketlerde Emredici Hükümler İlkesi' (Mandatory Provision in Joint-Stock Companies under the new Turkish Commercial Code) (2012) 18(2) Marmara Üniversitesi Hukuk Fakültesi Hukuk Araştırmaları Dergisi 311, 312 <<http://dosya.marmara.edu.tr/huk/fak%C3%BClteredergisi/2012C.18.S.2/7.oturum.pdf>> accessed on 26 June 2015

⁵⁴ Yunus Emre Akdoğan and Melek Acar Boyacıoğlu, 'Corporate Governance in Turkey: An Overview' (2010) 24 Selçuk Üniversitesi Sosyal Bilimler Enstitüsü Dergisi 11, 27.

increase investor confidence by minimising information asymmetry. This in turn reduces the uncertainty in the investment environment and increases the attractiveness of companies. Facilitation of information gathering by good disclosure is seen as an important part of the creation of an ‘investor friendly’ environment given that foreign shareholders hold around 60% of market capitalization on Borsa Istanbul.⁵⁵

All of the specific rules and provisions, which will be discussed later in this chapter, signal the positive relationship between increased corporate transparency and enforcement of corporate governance as a consequence of the new law.

2.1 The right to obtain information and inspection

The previous TCC stated that financial statements to be disclosed to the public should be made available to the shareholders at least fifteen days prior to the general assembly meeting.⁵⁶ As it is understood, the previous TCC regulated the right to obtain information in a passive way. This means that the provision did not allow for the active acquisition of information by investors by addressing questions to the BoD or auditors of the company. They could only obtain information disclosed to them by the company fifteen days before the general assembly. The previous TCC was enabling the investigation rather than the acquisition of information.

As a consequence, there was no provision on procedures for obtaining information and examining the documents in technical terms outside the general assembly. The legislator gave importance to keeping investors periodically informed instead of continuously informed. Moreover, the concept of ‘commercial secret’ constituted the main reason behind preventing the proper exercise of this right. Companies were able

⁵⁵Central Registry Agency , Exchange Trend Reports (2012) , 9,
https://www.mkk.com.tr/wps/wcm/connect/2baf295f-d91d-45f2-ad2b-34b23bd5cafc/Borsa_Trendleri_Raporu_I.pdf?MOD=AJPERES> accessed on 23 June 2015.

⁵⁶ The Republic of Turkey, Obsolete Turkish Commercial Code Law No. 6762 (9 July1956) Articles 362-363.

to refuse to give information to investors by stating commercial secrets as a reason.⁵⁷

The protection of commercial secrets by law is specifically mentioned in the Constitution, but the scope of commercial secrets should be well-defined by law to prevent instances of misuse.⁵⁸ However, there was neither a legal definition nor a judicial decision on what a commercial secret was under Turkish law.⁵⁹ Therefore, the limit of the concept could be largely misused by directors of corporations.

In terms of the right to obtain information, Capital Markets Law conformed to the TCC. It did not include a provision on the right to obtain information, but instead regulated public disclosure.⁶⁰ Even though the corporate governance principles of the CMB make reference to this issue, they are mostly general suggestions that outline a passive and indirect way of information gathering, which is, again, through public disclosure.

Moreover, keeping investors informed in accordance with corporate governance principles entails some problems in practice. As mentioned before, the ability to obtain information can be limited by the Articles of Association of Turkish companies. These limits are determined by the directors of companies, who also have the last word about informing investors. Therefore, it has become much easier for companies to hide information from investors. Consequently, both the previous TCC and the Capital Markets Law were unable to effectively regulate the right of investors

⁵⁷ Reha Poroy, Ünal Tekinalp and Ersin Çamoğlu, *Ortaklıklar ve Kooperatif Hukuku (Partnerships and Cooperative Law)* (8th Edn., Beta Yayıncılık, 2000), 550. See also Arslan Kaya, *Anonim Ortaklıkta Pay Sahibinin Bilgi Alma Hakkı (The Right to Obtain Information in Joint-Stock Companies)* (Bankacılık ve Ticaret Hukuku Araştırma Enstitüsü, 2001), 22.

⁵⁸ Constitution of Republic of Turkey, Article 26.

⁵⁹ Yrg 8 HD 17.03.1987 dated 1987/1469 E 1987 / 2337 K. states that the ‘secret’ protected under the Article 363 of the previous TCC is the ‘commercial secret’ and the law does not define the scope of this concept. Accordingly, any information regarding skills and methods of manufacturing, trade and production can be a ‘commercial secret’.

⁶⁰ Capital Markets Board of Turkey, Capital Market Law No. 6362 (6 December 2012) See Articles 4-15 and Article 128(b).

to obtain information. Turkish companies have become ‘closed-books’ for foreign investors, because it is difficult and costly for them to physically attend a general assembly and obtain information. Investors can also obtain company related information by attending the general assembly of the companies. However, in this case, they may have to wait up to a year to obtain information. In such a long time, the information can be useless for investors.

The right to obtain information under the new TCC is regulated in a different way compared to the previous TCC. The concept of corporate governance under the new TCC is in effect used as a way to find solutions to the conflicting interests between investors and company management. The new TCC grants investors the ability to investigate and obtain information about the company in a more secure and extensive way compared to the previous system. It reinforces the position of investors, as it enables them to obtain more information about the company and assure themselves from an investor perspective that their financial benefits are secure and whether their investments are being managed well.

Article 437 of the TCC provides that the right to obtain information is an indispensable right, which cannot be violated, restricted or made difficult to exercise.⁶¹ All the investors have the right to obtain information on the accounts regarding dividends and loss, balance sheet, the annual report and the proposals concerning the distribution of the dividend and the auditors’ reports from the company itself or the independent auditor.⁶² The retrospective right to obtain information that was regulated in the previous code has been preserved intact. In addition, Article 437

⁶¹ The Republic of Turkey, Turkish Commercial Code Law No. 6102 (31 January 2011) Article 437(6)

⁶² Ibid Article 437

enables investors to obtain information by addressing questions to members of the BoD or auditors in the General Assembly.

An important and novel aspect provided in Article 437 is that group of companies are included in the scope of the right to obtain information. Previously, holding companies were not required to disclose information about their affiliates. Under the new TCC, the management of the parent companies are required to disclose consolidated financial statements, as it will be discussed later in this chapter. Suffice it to say here that it is the first time under Turkish law that the relations between the parent company and its affiliates are subject to disclosure by the parent company and investigation are regulated from an investor protection perspective.

Another novelty of the new TCC on the right to obtain information is the equal treatment principle. Article 437 requires that if an investor is given information outside the General Assembly, then such information must be given to requesting investors in the same manner and detail.⁶³ In such a case, the company cannot refrain from providing information, even though it may constitute a commercial secret and such a request may not have been on the agenda of the meeting. This shows that the company cannot discriminate between majority and minority investors by stating that the information provided is a 'commercial secret'. Even though in this way commercial secrets of the company would be disclosed or other company benefits jeopardised, the company must share such information to any requesting investors if this information has already been given to an investor. Recalling the fact that most public companies in Turkey belong to a shareholder with controlling power, the rules on the right to obtain information have limited the risk of the shareholder, who has the controlling shares, to abuse this power against the interests of minority investors. Such

⁶³ Ibid Article 437(2)

a development is beneficial to minority investors as it will strengthen the equality of opportunities among investors to obtain information, it will give investors greater transparency and the opportunity to exercise more scrutiny over the company operations and ultimately will protect themselves against losses.

Article 437 aims to ensure that investors achieve an appropriate understanding of their investment, including their rights and the relationship between risk and return. Providing efficient and concise ways to obtain information is directly linked with this aim. Investors need to obtain any information they need in order to evaluate whether their financial interests are secure. In contrast to the previous law, Article 437 prevents companies from refusing to provide information to enable the exercise of the right to obtain information. For that purpose, Article 437 expands the scope of the information right in a manner that restricts the exceptions only to commercial secrets and company benefits.⁶⁴

However, there is a fundamental flaw in determining the limit of a commercial secret, because there is no definition for it in the new TCC either. To prevent companies from refusing to provide information using a commercial secret as an excuse, Article 437 sets its limit by indicating ‘other company related benefits are jeopardised’ as a scale. The preamble of the TCC gives sharing commercial secrets with rivals as an example of jeopardising other company related benefits stating that when the company shares its commercial secrets, company incur losses. This is detrimental to interests of the company and investors. However, this scale may lead to difficulties in practice, because the preamble of the law states that the meaning of jeopardise does not only cover the loss of assets.⁶⁵ There are no concrete limits to the ‘other company benefits

⁶⁴ Ibid Article 437(3)

⁶⁵ The Preamble of Turkish Commercial Code Law No. 6102, Article 437(3)

are jeopardised' concept in this Article. Therefore, it can be interpreted very flexibly by the controlling shareholders and could still be used as a pretence not to disclose information to investors.

In the Turkish business culture, there is the possibility that the inappropriate exercise of control by majority shareholders cannot always be prohibited by the Articles of Association. It is necessary to regulate rights and have protecting measures on minority investors in place in order to strike the right balance between the interests of majority and minority shareholders and support these rights through litigation. To prevent investors suffering because of this, the right to obtain information has been strengthened by litigation.

The most important regulation that strengthens investor rights is that an investor may apply to a court if a demand for information is not responded to or it is rejected with no valid reason or it is deferred so the investor cannot get information in accordance with Article 437.⁶⁶ In this case, if companies do not fulfil their obligation of disclosure or if the investors do not consider the reason that prevents the disclosure of information adequate or valid, investors are allowed to seek recourse through lawsuit. Each shareholder can demand compensation from the parent and the responsible board members. The right to claim compensation is one of the most significant provisions in the new TCC which was designed to fill in the gaps in relation to minority shareholder protection under the TCC. It is clear that these rules will reduce the risk of losses caused by the dominant position of controlling shareholders in company groups.

While the new TCC maintains the previous investors' rights, it also introduces new rights to investors. Pursuant to Article 438, any investor has the right to request the

⁶⁶ New TCC No.6102 (n. 61), Article 437(5).

appointment of a special auditor even if the subject of the audit is not included in the General Assembly agenda.⁶⁷ Investors are entitled to inform or draw the attention of auditors to matters, which they find suspicious and ask for the necessary explanations. As such, a special audit allows for the application of the rights of investors as it enables them to obtain enlightening information on precise facts related to the administration of the company. This provision is the counterpart of Article 348 of the previous TCC which required holding shares corresponding to at least 1/10th of the principle capital at least 6 months in advance.⁶⁸ Article 348 of the previous TCC lacked clarity on the special auditor request process and the rights and responsibilities of the special auditor.⁶⁹ Even though the right to request a special audit was also regulated under the previous TCC, the conditions to exercise the right considerably reduced the expected benefits of a special audit for investors in practice. With the abolition of the previous TCC, the threshold was removed. Thus, the right has been transformed from being a minority right to an individual right because, under the current TCC, every investor is allowed to request a special audit on the condition that the investors must have used all their rights to obtain information and or force inspection.

Assignment of a special auditor should be done through the court and this can happen even if the General Assembly has not accepted it. The appointment of special auditors by the court is an improvement of the new TCC. This is an advancement of the regulation from an investor perspective. Previously, special auditors were appointed by the General Assembly. Most of the time, the controlling shareholder assigned the special auditor that they had also chosen themselves. Consequently, these special

⁶⁷ Ibid Article 438(1)

⁶⁸ Obsolete TCC (n. 56) Article 348

⁶⁹ Şirin Güven, 'Special Audit in Corporation Law, in accordance with Turkish Commercial Code No. 6102' (2011) 7(2) Çankaya University Journal of Law 133, 134.

auditors performed the auditing in line with the majority shareholder's demands or interests.⁷⁰ Therefore, the assignment of an objective, special auditor by the court will provide confidence to the investors.

To submit the special audit report only to the requesting investors would not give a satisfactory result in terms of achieving the objectives of the special audit. To this end, BoD are required to present the special audit report and the BoD's assessment report in the first General Assembly.⁷¹ Each investor can request a copy of these reports within one year following the General Assembly. In this sense, special auditing is proposed to satisfy its object, because on the one hand it provides reliable information to the investors and on the other the information is equally available to all investors.

However, if the General Assembly was allowed to reject the claim and shareholders were unable to challenge it, then the right to request a special auditor turns into a minority right, as is apparent from Article 439.⁷² It is clear that the lawmakers aimed to prevent the misuse of this right by changing the conditions of request for a special audit in case of rejection by the General Assembly. That said, additional conditions prescribed in case of rejection are likely to pose obstacles to investors exercising their information right, which contradicts the aims pursued by the improvements of the new TCC.

The system for obtaining information set out in the previous TCC was not working effectively. Despite its flaws, the new TCC remedies the failures of the previous TCC. Taking the business culture realities into consideration, the right to obtain information has been significantly improved. Wider rights that were not included under the

⁷⁰ Ibid

⁷¹ New TCC No. 6102 (n. 61) Article 443(1)

⁷² Ibid Article 349

previous TCC, such as appointment of special auditor by shareholders, compensation demand from companies for the loss of investors and companies prevented from refusing to provide information, are now provided. As far as investors are concerned, the scope of application of their right to information has been expanded. Strengthening investors' rights is ensured by shaping and enriching those rights that already exist, and by granting new rights that allow investors to seek recourse through litigation. Information asymmetry between investors and controlling shareholders has been reduced. Moreover, the right to request a special audit permits investors to prevent the misuse of power by majority shareholders by providing information on the administration of the company. As a result, all of the investors will benefit from the newly strengthened rights.

The right to obtain information is a means to reduce investors' costly information obtaining activities. The data provided in the Table 1 shows that foreign investors tend to invest primarily in companies with good corporate governance. This illustrates that foreign investors show a preference for those aspects of corporate governance that eliminate information disadvantage. Consistent with this idea, it is proposed that improved information accessibility by investors as a result of these amendments in the new TCC has a positive impact on the perception of foreign investors which results in greater foreign investment in Borsa Istanbul.

2.2 Groups of companies

The issues related to groups of companies are of great importance for the Turkish economy. In terms of scale, groups of companies dominate Borsa Istanbul. Family groups of companies directly or indirectly own the majority of all companies traded

on Borsa Istanbul and maintain the majority control.⁷³ However, there has not been any legal regulation that refers to family groups in Turkey. The previous TCC neither provided an official definition for groups of companies nor contained any rules regarding their legal status quo. As a result of a pyramidal ownership structure, parent companies can enjoy certain control rights over the affiliated companies' assets and use their rights to exert influence over decision-making processes in these companies.⁷⁴

In Turkey, such problems related to liability of groups of companies have been dealt with by court decisions or specific references made in different regulations. Before the new TCC, there was no specific law to protect investors from the abuse of control rights by the parent company. Therefore, due to ineffective protection, there was a high potential for abuse. Controlling shareholders were able to impose arrangements that went against the interests of the company as a whole and minority shareholders in order to protect the interests of the parent company.⁷⁵ In case those investors complained about such abuses, the protection came from the judiciary. At this instance, the problems arose because the judicial system was not experienced in solving the problems of investors since it had not developed a philosophy to pierce the corporate veil for investors of corporate groups aiming at protecting investors from the abuse of control rights by the parent company.⁷⁶ This situation was even more complicated for foreign investors, who lacked knowledge of local laws and

⁷³ 'Patronlara, 'Halka açılın, şirketlerin ömrü uzasın' çağrısı' (Call for Bosses: Go Public to Extend the Life of Companies) *Hürriyet Ekonomi* 23 January 2010 < <http://www.hurriyet.com.tr/ekonomi/13560903.asp>> accessed on 28 June 2015

⁷⁴ Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Tunnelling' (2000) 90(2) *The American Economic Review* 22, 26.

⁷⁵ Yüksel (n. 3), 103.

⁷⁶ OECD, (n. 29), 73.

administrative procedures. Thus, the fear of expropriation resulting from the non-transparent relations within groups of companies further deterred foreign investors.

In addition, unavailability of information about the groups of companies due to lax transparency and disclosure rules and weak enforcement in Turkish legislation has led to information asymmetry between the controlling shareholders and investors within a group structure. Ideally, foreign investors should be able to easily obtain meaningful information on companies, but this was not the case in Turkish groups of companies. This suggests that foreign investors are less likely to invest in these family controlled groups of companies in which the internal relations and arrangements are not transparent.

In Turkey, groups of companies are at the centre of economic activity at domestic level.⁷⁷ Thus, by regulating groups of companies, the new TCC aims to create a very general regulatory system in an attempt to balance the realities of economic life and the rule of law. The main purpose for imposing significant obligations on parent companies under the new TCC is to provide a certain level of transparency for investors by regulating the relationship between parent companies and their affiliates. These provisions are intended to eliminate the former practice, which was to hold the board members of an affiliated company responsible without considering the instructions provided by the parent company.

For the first time under Turkish law the relations between parent companies and their affiliates have become the subject of a uniform set of principles and policies. Thus, the new Code has dedicated 16 articles on how to improve corporate accountability by

⁷⁷ The Preamble of TCC (n. 65), Articles 69-70.

considering the groups of companies as one entity.⁷⁸ The new TCC introduced an extensive definition of groups of companies. These are defined by reference to the concept of ‘dominance’ instead of the level of shareholding.⁷⁹ Even though the definition of ‘dominance’ is not clearly specified, the sources of dominant power are listed in Article 195.⁸⁰ The characteristic of the Turkish company ownership structure gives rise to a pyramidal structure, as described in the third chapter. This ownership structure in Turkish companies raises the issue of indirect control, which is when a company controls another company through affiliate companies or together with them. Controlling families effectuate control by complex inter-corporate shareholdings. In this way, they obtain direct decision-making power without having a direct high level of shareholding. Therefore, the shareholding level is not always an indication of control over another company. When majority owners exercise excessive control over the affiliates, the possibility of abusing their position increases.⁸¹ They have the possibility to transfer the capital and assets of the companies in the same group in a way that puts them in an advantageous position at the expense of other investors. It is proposed that defining the groups of companies by referring to dominance instead of shareholding level is a better way to reflect the realities of economic life in Turkey in relation to the rule of law. The relation of dominance can be direct or indirect. Thus, an affiliate company cannot avoid having to prepare consolidated financial accounts by proving there is no dominance through direct decision-making power of the parent company. Consequently, achieving transparency and accountability in groups of companies cannot be prevented.

⁷⁸ New TCC No. 6102 (n. 61) Articles 195-210.

⁷⁹ Ibid Article 195(1)

⁸⁰ Ibid

⁸¹ Lucian Arye Bebchuk, ‘Efficient and Inefficient Sales of Corporate Control’ (1994) 109(4) The Quarterly Journal of Economics 957, 962-964. See also Joseph E. Stiglitz, ‘Credit Markets and the Control of Capital’ (1985) 17(2) Journal of Money, Credit and Banking 133, 147.

The TCC introduces liability provisions for groups of companies.⁸² The crucial aspect of liability is that it covers not only actual financial losses, but also any disadvantageous situations, such as potential losses relating to the assets or the profitability of the affiliate. If the losses that have incurred as a consequence of a disadvantageous situation are not compensated during the same fiscal year, or if the investors are not granted a right of claim, each investor of the affiliate company may seek compensation from the parent company.⁸³ Accordingly, the investors of the affiliated companies are granted a right of claim for being remedied from the parent company unless any losses incurred are compensated during the same fiscal year.

Article 202 of the new TCC emphasizes two situations of abuse of dominance. The first one is related to financial losses that the subsidiary company faces as a result of decisions exercised by the BoD of the parent company that are considered to be breaches of the BoD's duty of care. Some examples of such transactions are transfer of business, assets, funds, receivables, personnel, and debts; reduction/transfer of profits; resolutions or prohibitions, such as the restriction or interruption of investments that may negatively affect activities or productivity, or prevent the progress of the affiliate company.⁸⁴ The second situation is financial losses resulting from important structural decisions adopted in the General Assembly, for instance, mergers, spin-off, change of type of business structure or dissolution and the issuance of stocks or securities, or amendments to the Articles of Association.⁸⁵

⁸² New TCC No. 6102 (n. 61) Article 202.

⁸³ Ibid Article 202 (1/b).

⁸⁴ Ibid Article 202(1).

⁸⁵ Ibid Article 202(2).

While the notion of exercising control over another company is not *per se* illegal, the new TCC has brought in restrictions with respect to the exercise of control from the parent company and provides that certain circumstances are considered illegal in order to protect minority investors. Even though the law does not prohibit the transfer of resources within groups of companies, it mandates disclosure of the transactions in order to make these actions transparent to all investors. In addition, the law entitles the shareholders of the parent company to request reports on the financial status of affiliate companies at the general assembly meetings of the parent company.⁸⁶ Regarding the partial dominance, a parent company cannot use its control power over the affiliated company in a manner that would cause detrimental effects for the affiliate.⁸⁷ Misuse of control rights through transactions underlined in Article 202 by the parent company is prevented by law. It is a unique regulation as it covers every misuse of dominance without limiting it to certain types of transactions.

One can argue that it is not objectionable for an affiliate to support its parent company as long as the subsidiary itself is not in danger of bankruptcy. At this point, fairness for minority investors becomes an issue. To prevent unfairness, the related articles of the new Code propose remedies for expropriation. In addition, in the case of expropriation resulting from the dominant position of the controlling shareholder on the affiliates, the law should mandate a change in the BoD of the parent company, since they cannot make objective decisions which would not have any detrimental effect on investors. Furthermore, the law should prohibit the previous BoD from being re-elected as another means to further strengthen minority investor rights.

⁸⁶ Ibid Article 200.

⁸⁷ Ibid Article 202.

One of the most interesting aspects of the new TCC is that in order to increase transparency in relation to groups of companies' relations and to reduce the possibility of controlling shareholders abusing their position through the dominant company, Article 199 of the TCC stipulates that the affiliates are required to prepare an annual 'affiliation report'.⁸⁸ Pursuant to this Article, the report should show the scale of the relationship between parent and affiliate companies, including all the legal transactions which the company conducted with any company in the same group. The report should explain the legal transactions upon the direction of the parent company concluded in favour of another company in the same group during the last year of operation and all the precautions taken or avoided in favour of these companies, the reasons for the precautions, the losses resulting from these and the benefits provided thereof. However, the wording of this Article may result in different interpretations. Article 199 of the new TCC states that '... the legal transactions made with the parent company or a subsidiary of the parent company, or made in favour of the parent company or one of its subsidiaries upon the direction of the parent company'.⁸⁹ More particularly, the interpretation of the phrase 'upon the direction of the parent company' is not sufficiently clear. Also, the preamble of the Article does not offer any explanation to that end. In this case, there exists a lacuna within the legislation since this phrase can be interpreted as a condition to explain the legal transactions between the parent company and its affiliates. This would raise the possibility that companies can avoid explaining the transactions stating that the transaction was not made upon the direction of the parent company.

⁸⁸ Ibid Article 199.

⁸⁹ Ibid 199(3)

For the regulation to achieve its purpose of increasing transparency in groups of companies for all investors, all of the transactions made upon the direction of the parent company, including those that are not made with any of the companies in the group, that are made by the affiliates in favour of any company in the same group, should be included in the affiliation report without being subject to any other conditions.

The affiliation report helps investors to determine the economic side of the legal transactions.⁹⁰ In other words, it aims to inform the investors on how being a part of a group of company affects the affiliates' financial situation. For this purpose, Article 199 states that the affiliation report should justify the loss by the affiliate company, as a result of a parent company's decision. In addition, it also has to clarify whether the loss is paid back or is planned to be paid.⁹¹ In the event of a violation of this Article by the companies within the group company, judicial fines will be imposed.⁹² The affiliation report constitutes a basis for the exercise of certain rights with regard to obtaining information, conducting investigations and forming the basis for compensation lawsuits to be filed, which are granted to investors under the TCC. For these reasons, the comprehensibility of the report by all investors is of paramount significance. To this end, the affiliation report should explain the losses instead of simply giving the numbers, as it is possible that not all investors can understand and analyse the financial data. Explanation of losses is one of the most striking changes brought about by the new TCC and enables investors to better understand the economic situation of groups of companies and the results of the transactions made between parent company and affiliated companies or between affiliated companies.

⁹⁰ The Preamble of TCC (n. 65) Article 199

⁹¹ The new TCC No. 6102 (n. 61) Article 199 (1).

⁹² Ibid Article 562(3).

This is a welcome development, which essentially reduces the concerns of investors about the possibility of financial losses, not being stated in the balance sheets of the companies.

As one can see, the right of investors to obtain information on the financial situation of affiliated companies has been extended and it is guaranteed by judicial fines. Parent companies are prevented from using their controlling power in a way that is detrimental to their affiliates. Disclosure of information about the financial situation of affiliated companies will likely decrease the expropriation risk of investors in Turkish companies in which it is difficult to understand the nested ownership structure and activities of family owned groups of companies.

In addition, in case of abuse of dominance through important decisions adopted in the General Assembly that are not based upon clearly understandable grounds concerning the affiliate company, investors, who have attended the General Assembly, but have cast negative votes, are entitled to claim compensation for their losses from the controlling company or demand from the court that their shares are sold at least at the price quoted by the stock exchange; if this is not available, at their actual price or a price to be determined by a generally accepted method.⁹³ These rules on the one hand increase transparency within groups of companies and on the other hand regulate minority protection more extensively and effectively. Investors are protected against being treated unfairly. The effectuation of new minority rights being in accordance with the transparency principle will have a positive impact on the perception of foreign investors.

⁹³ Ibid Article 202(2). Such claims will be subject to a time bar of two years beginning from the relevant general assembly meeting date or announcement of the relevant board resolution.

The previous TCC did not include any provisions regarding the relations of groups of companies. The ineffectiveness of the previous auditing system of groups of companies became an obstacle to the effective monitoring of their activities. This ineffectiveness increased the ability of groups of companies to create hidden reserves that enabled the controlling shareholders to conceal the companies' actual financial situation and to transfer the company's profits to affiliate companies.⁹⁴ Even though the regulations of the Capital Markets Law impose the obligation on listed parent companies to prepare consolidated financial statements for their listed affiliates, non-listed affiliates could create hidden reserves. This prevents the non-controlling investors from receiving dividends, which is a major problem for minority shareholders under Turkish law.⁹⁵ It is clear that such an audit system makes it difficult for Turkey to attract foreign capital. Foreign investors would like to know that they will get a return on their investment. Evaluation of the real rate of return will be possible only when foreign investors are able to obtain information and monitor the affiliated companies.

To provide a full and clear audit result for all investors and thus improve the culture of transparency and accountability in groups of companies, Article 406 of the new TCC introduces a special audit for affiliate companies.⁹⁶ Investors have the right to request a special auditor to inspect the transactions of the company with one of the other companies of the same group of companies.⁹⁷ Pursuant to the article 403, auditors express their view at the end of the audition with an opinion letter.⁹⁸ The auditor can

⁹⁴ Sibel Hacımahmutoğlu, 'The Problems of Minority Protection and Their Solutions within the Legal Framework in Turkish Corporate Governance' (2007) 8(2) *Journal of Banking Regulation* 131, 145.

⁹⁵ For the cases and the decisions of the Turkish High Court on distribution of dividends to shareholders in PLCs See Poroy, Tekinalp and Camoğlu (n. 57), 513–519.

⁹⁶ The new TCC No. 6102 (n. 61) Article 406.

⁹⁷ There are two circumstances that lead up to assignment of a special auditor. See New TCC (n. 61) Article 406 (1/a) and (1/b)

⁹⁸ *Ibid* Article 403

express 3 types of opinions; positive view, restricted positive view and negative view. Avoiding from expressing opinion has also been formulated in this Article. When a contradiction which has effects at the results announced in the financial statements exists, auditors may express restricted positive view provided that these contradictions can be corrected by authorised committees. When there exists an uncertainty which do not enable to reach a conclusion or restrictions by the company during audition, the auditors can avoid from expressing opinions.⁹⁹ The parent-affiliate company relations can be the reason for the auditor to express restricted positive view or avoid from expressing opinion. In equity investment, investors take the risk that they might lose their money. Therefore, they want to know what happens to the money they invest. In fact, if they know how their money is used, they can manage investment risk to their advantage. Turkish legislation is increasingly making this possible. It strives to ensure that investors can obtain reliable information on all crucial issues relating to groups of companies' operations and rely on them to ascertain that the companies are run properly and soundly.

It can be seen that the scope of rights that investors are given by Article 438 is extended by Article 406 that states that every investor has the right to ask for an independent auditor to shed light on the relations between companies in the same group. In contrast to Article 438, Article 406 states that it is not possible to refuse a request by the General Assembly. These articles are set to create a new mandatory transparency regime that is beyond the proper disclosure of company information for company groups to provide transparency to investors of company groups.

⁹⁹ Ibid Article 403(3) and 403(4)

When the previous TCC was enacted, the legislator took a broad view of the interests of the controlling shareholder of the group rather than of the minority shareholders of the affiliated companies. A possible explanation for this is that there was neither an established stock exchange nor investors investing in these groups of companies at that time. Therefore, the lawmakers did not consider regulating the transfer of resources from an affiliate to another company in the same group. However, today, foreign investors' share in market capitalization is at a level of 60% in Borsa Istanbul. Therefore, disclosure and transparency requirements are important for foreign investors to understand the economic situation of the companies within a group, so that they can assess the possible risks they may face. After the enactment of the new TCC, the structure of corporate groups in Turkey became more transparent to all interest groups compared to the previous regime. The flow of and right to obtain information are now regulated under the new TCC. Accordingly, more transparency is sought in the financial statements and all the reports of individual companies and groups of companies. By making information about affiliated companies more accessible, the law also allows a much better understanding of the actual economic position of the group companies.

The new TCC provides an advanced liability regime for company groups. This regime will change the nature of control applied over the subsidiaries by parent companies. These deep-rooted changes that integrate the principles of transparency and accountability for Turkish companies play an effective role in considering groups of companies as a single company under certain conditions. The support of the judiciary will also lead to higher transparency within corporate groups. Even though transparency within corporate groups will be increased by this innovative regime, the misuse of controlling power and disappear of pyramidal ownership structure entirely

from the culture of Turkish business will take time because corporate culture does not change immediately by changing the commercial code. In spite of that, these rules are good news for foreign investors. The new TCC creates a more foreign investor friendly environment which reduces the perceived risk of loss and facilitates the increase of capital flow into Turkey.

2.3 The use of information technology

In the last two decades, developments in information technologies have been rapidly increased. These developments have dramatically altered the way companies communicate effective and qualified information to investors.¹⁰⁰ It is now possible to do this in a faster and less costly way. Due to the rapid improvement in technology, the previous TCC became obsolete for meeting the expectations of investors. The government in Turkey hesitated to use internet technologies until the enactment of the new TCC, which considers the usage of these technologies necessary to provide transparency to all investors. With the provisions of the new TCC, Turkey has taken part in the innovative trends of the business world, and internet technologies have been introduced into the legislative system.¹⁰¹

To use internet technologies effectively, the new TCC introduced an online General Assembly into the legislative system. The General Assembly is important for investors because it provides an opportunity for them to influence how the company is run.¹⁰² However, since investors are spread across a growing geographical area, it is

¹⁰⁰ George P. Kobler, 'Shareholder Voting over the Internet: A Proposal for Increasing Shareholder Participation in Corporate Governance' (1998) 49(2) Alabama Law Review 673, 674.

¹⁰¹ Articles 1524-1527 of the new TCC regulate the usage of electronic media and information society services. For the purpose of this research, the meetings other than online general assembly will not be referred.

¹⁰² Frank D. Emerson and Franklin C. Latham, *Shareholder Democracy: A Broader Outlook For Corporations* (Press of Western Reserve University, 1954) 6.

inconvenient for them to attend the meetings.¹⁰³ Article 370 and 371 of the obsolete TCC required the meeting of the General Assembly to be held in a particular place.¹⁰⁴ Thus, investors were required to be present in person in a particular place in order to exercise their voting rights. Although, it is stated that the General Assembly can be held in a place other than where the company headquarter is, this did not change the condition for there to be a real (actual) meeting place. Accordingly, the General Assembly could be convened in a particular place, and it was not possible to hold the meeting in more than one places. Since the previous law held it to be mandatory for investors to attend the General Assembly in order to exercise their voting rights, in other words, the presence of investors in the meeting was required, a General Assembly held with the help of electronic media was not possible.¹⁰⁵

In many instances, it is not easy to attend in person the General Assembly of a joint-stock company due to the distance, high costs and time constraints. It makes little sense for a minority investor in a city, such as Adana or Gaziantep, to participate in a General Assembly in Istanbul, and this is also the case for a British shareholder who holds shares in BOSSA to travel to Adana, especially considering that there are technologies that companies can use that are less costly. Since investment behaviour is basically based on a costs and return analysis, it is not feasible for dispersed investors to attend in person the General Assemblies of every company they invest in. Research that analysed the institutional and company specific determinants of the tendency of institutional investors to participate in the shareholder meetings using a sample of 62 states, including Turkey, found that physical attendance has a strongly negative effect

¹⁰³ Kobler (n. 100), 675.

¹⁰⁴ Obsolete TCC (n. 56) Articles 370-371.

¹⁰⁵ Ibid. Articles 360(1), 360(2), 360(3), 368 and 376 are some of the other provisions that disabled electronic General Assembly meeting of shareholders.

on the percentage voting.¹⁰⁶ In addition to this, participation in the General Assemblies of joint stock companies, except by controlling shareholders, is very low in most Turkish companies.¹⁰⁷

Article 1527 of the new TCC establishes the legal basis of the board meetings to be held through online audio-visual gathering and the use of online votes.¹⁰⁸ Online General Assemblies have been introduced to remove the barriers to effective cross-border voting in Turkey. Four conditions have been provided in order to hold these meetings online. First of all, it is required that the investors notify the company about their intention to use the new system.¹⁰⁹ Companies are required to set up a website specifically for this purpose. The suitability of electronic tools that allow for such participation has to be proven by way of a technical report, and such a report has to be registered and published on the companies' website. Lastly, the identities of voters have to be concealed due to confidentiality.

Electronic attendance at General Assemblies is another advantage provided to investors by the new TCC. Any investor with an internet connection can become an active shareholder, and participate and vote at annual shareholder meetings from anywhere around the world. These new rules are of special interest to foreign investors, who have in the past experienced problems participating in General

¹⁰⁶ Melsa Ararat and Burçin Yurtoğlu, 'Uluslararası Kurumsal Yatırımcıların Genel Kurullara Katılımı ve Oy Kullanma Eğilimleri'(Institutional and Company Specific Determinants of International Institutional Investors' Tendency to Vote at General Assemblies) (2013) 28(322) İktisat İşletme ve Finans 61, 65.

¹⁰⁷ Pulaşlı (n. 24), 16.

¹⁰⁸ The new TCC (n. 61) Article 1527. Article 1527(6) stated that the online General Assemblies and the online use of votes shall be regulated with a separate communique, See The Communiqué on Electronic General Assembly Meeting System to be Implemented at the General Assembly Meeting of Joint-Stock Companies Official Gazette No 28395 (28 September 2012).

¹⁰⁹ New TCC (n. 61) Article 1528.

Assemblies in person when they were conducted in Turkey.¹¹⁰ One of the objectives of the new TCC is to improve investor protection and empowerment through enhanced disclosure. Various articles of the previous TCC were burdensome for foreign investors and made it difficult to exercise their rights. In order to overcome this problem, the new TCC reinforces the notion of transparency with extensive disclosure measures, such as online meetings. This is a big step forward from the previous TCC under which only investors, who attended shareholder meetings in person, could use their rights.

One of the weaknesses of the new TCC is that it does not explain the legal status of a General Assembly that suffers from technical problems during the meeting. Provisions to regulate such an issue would be worth being considered, because these technical problems may occur due to entirely technical reasons, such as internet outage, as well as managerial-based reasons.¹¹¹ These problems may result in coordination and communication problems and pose an obstacle to attend and exercise of rights. In such cases, whether the company can be held responsible or not becomes the issue since the company has an obligation to ensure the safety of usage of the electronic media. It is proposed that the company can only be held responsible for technical problems if the defects can be attributed to the company's negligence. However, there is no provision in the new TCC clarifying the situation in cases of non-company originated technical problems, such as attacks by hackers. In this respect, the existing rules are insufficient. Further rules to resolve a technical failure in a manner that would affect the continuity

¹¹⁰ It should be noted that the General Assembly meetings do not have to be held electronically only. The law requires that meetings are held physically and investors are allowed to attend the meetings by electronic media.

¹¹¹ Fatih Bilgili, 'İnternet ve Anonim Ortaklıklar Genel Kurul Toplantısı' (Internet and General Meetings in Joint-Stock Companies) in Rona Serozan and others *Prof.Dr.Necip Kocayusufpaşaoğlu'na için Armağan* (Yelken Kitapevi 2008), 581.

of the meeting are necessary. Therefore, it is proposed that there is a need for additional rules to support the reliability of electronic meetings.

Despite its flaws, facilitation of electronic media usage is seen as an important initiative, since foreign investors own 60-70% of stocks traded on Borsa Istanbul. The new system facilitates participation by eliminating the need for proxies and costs associated with them; it also saves investors the burden of time-consuming travel. This legislation is new and the regulations regarding the use of information technologies are subject to improvement as there is still much room for improvement. It is beyond doubt that further developments will be observed in time.

Conclusion

The law has an important role in defining the field within which the exercise of discretion by company managers can be exercised. The new TCC determines the roles of investors and managers in the decision-making process of a company and the powers available to managers in running a company. The previous law had increasingly come to be regarded as inadequate because it was not fit to adequately accommodate the needs of investors. First of all, it was clearly outdated, it did not take adequate precautions to protect minority shareholders and it was dealing with problems occurred as a result of the managers' wide powers. There was not much emphasis given on transparency and accountability in respect of the decisions of managers which may be undesirable for the investors. Therefore, it became easier for managers to take advantage of the absence of updated and sophisticated rules. However, equity investors value good management¹¹² and many foreign investors

¹¹² Philip Rosenblatt and Marat Terterov, *Turkey: A Business and Investment Review* (GMB Publishing, 2006), 45.

recognise Turkey's judicial system as slow, complex and inefficient.¹¹³ This is one of the problems that appear to prevent the development of the investment environment in Turkey.

Corporate governance is a monitoring device for investors because it develops control mechanisms focusing on supervision of management and satisfying legitimate expectations for transparency and accountability. It increases investors' confidence by minimizing the expropriation risk of individuals in charge of the company. Each of these issues is of crucial importance to the long-term relationship between investors and companies and the valuation of investors' shareholdings.¹¹⁴ From the early days of corporate governance in Turkey, the principles are laid down on a voluntary basis. Most of the times, the lawmakers refrained from intervening in a more decisive manner. Even though the CMB mandated listed companies to adopt the 'comply or explain' method, companies did not show any will for substantive compliance. Therefore, a change was needed, because foreign investors attach importance to effective rules and this influences their willingness to invest in the Turkish market.

This chapter investigated the relationship between corporate governance and foreign equity investment to determine whether or not corporate governance has been a factor in attracting foreign investors into the Turkish capital market. It was argued that foreign investors have welcomed corporate governance reforms that aim to reduce information asymmetry among investors. Consistent with this argument, the results indicate that corporate governance has been a determining factor and attractiveness of

¹¹³ The World Bank and the International Finance Corporation, *Doing Business 2013 Smarter Regulations for Small and Medium-Size Enterprises*, 202. <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf> accessed on 20 June 2015.

¹¹⁴ Marie Maher and Thomas Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' in Joseph A. McCahery, Piet Moerland, Theo Raaijmakers and Luc Renneboog (eds) *Convergence and Diversity of Corporate Governance Regimes and Capital Markets* (OUP, 2000), 404-411.

companies is affected by increased transparency and disclosure practices. In the absence of sufficient domestic equity investors, attracting foreign equity investors is the alternative for companies aiming to accumulate capital by equity investment. To attract foreign equity investors, more emphasis should be paid on corporate governance. After all, corporate governance goes hand in hand with better disclosure and transparency which would lead to a better influx of foreign investment.

The results suggest that foreign investors prefer those attribute of corporate governance that help to reduce informational disadvantage. Recalling the data given in Table 1, it is clear that foreign investors prefer to invest in companies in BIST-Corporate Governance Index because they interpret this willingness to disclose information about the companies listed in the corporate governance index as a signal of good corporate governance. Therefore, it can be stated that in an investment environment where transparency and information disclosure is low, companies with good corporate governance can attract more foreign investors. Also, the increase in the number of foreign investors in Table 2 signals that the strengthened role of investors, better disclosure obligations, facilitation to obtain information and better voting system have contributed to the attractiveness of the Turkish market.

Considering that only 47 of all listed companies has a corporate governance rating of 7 or more, the conclusion drawn is that the companies are not eager to implement these principles. It is suggested that non-compliance is attributed to the fact that the CMB principles do not have a legal sanction. When the findings of this Thesis are considered with La Porta et.al's findings, who have argued that the states with weak legal systems have the least developed capital markets, it is concluded that legal sanction is necessary to secure the implementation of corporate governance in Turkish

companies and provide a reliable investment environment for investors.¹¹⁵ Foreign investors face more informational problems in states with weak disclosure systems.¹¹⁶ Therefore, they tend to invest in companies with less information asymmetry.

It is argued that if corporate governance principles take the form of binding law, they would lose their flexibility.¹¹⁷ The new TCC adopts a mix method of voluntary implementation and binding law. With respect to specific aspects, such as transparency and accountability, which the companies refuse to implement without binding laws and thus voluntary implementation has not been sufficiently effective, the new system under the TCC has been set up in such a way so that companies are legally obliged to adhere to the new provisions. The remaining attributes of corporate governance are left to the voluntary approach. Extending the implementation of corporate governance principles further than 'comply or explain' only, it improves the transparency culture of companies. Within this framework, it is seen that the new TCC significantly contributes to the implementation of the corporate governance principles at a level sufficient to attract more foreign investors.

One of the main innovations of the new TCC pertaining to the joint-stock companies is the importance given to transparency. Transparency is a key element to attract foreign investors because it helps to assess the position of company and identify potential shortcomings. The chapter presented evidence about the effect of the recently introduced transparency and disclosure practices in the TCC and the reaction of foreign investors to these practices. With the new TCC, transparency and accountability have been in the centre of attention. Since the introduction of the new

¹¹⁵ La Porta, Lopez-De-Silanes, Shleifer and Vishny (n.12), 1149.

¹¹⁶ Christian Leuz, Karl V. Lins and Francis E. Warnock, 'Do Foreigners Invest Less in Poorly Governed Firms?' 22(8) *The Review of Financial Studies* 3245, 3248.

¹¹⁷ Wymeersch (n. 51), 157.

TCC, Borsa Istanbul has experienced a five-fold increase in the number of foreign investors. This illustrates that, despite its flaws, the reaction of foreign investors is positive to the reform of the TCC.

The new TCC has strengthened the legal status of all investors and has granted them more protection compared to the previous TCC. Such strengthening is provided by, on the one hand, improving those rights that exist under the previous TCC, such as disclosure of companies and, on the other hand, strengthening minority rights and granting of new rights to obtain information and seek recourse through litigation given to all investors.

It is proposed that the establishment of a regime based on disclosure, transparency and accountability has a positive impact on the investors' perception and has significantly reduced investment risks. Following the entry into force of the new TCC, all investors have benefited from these enriched rights. Stringent disclosure practices and expanded information obtaining rights limit the ability of insiders to expropriate investors. The new instruments provided to investors create a more foreign investor friendly environment which can attract more foreign investors into the Turkish capital market. The new TCC has removed the negative effect of the outdated previous TCC and assured foreign investors that a legal system that protects their interests is in place. The increased number of foreign investors shows that the improvements of the new TCC achieved its objective and the legal changes are overall welcomed by foreign equity investors.

Chapter 5

CONCLUSION

Equity investors, no matter whether they are domestic or foreign, share some common expectations and seek the same assurances when deciding to provide capital. Their decisions are mainly based on risk and returns of portfolio diversification. Ultimately, they prefer to place their capital where they can understand the risks and believe their investment is most likely to be protected from expropriation. In other words, if investors decide to invest time and money, they have to be informed about the way companies function.¹

The textbook models of economies diverge from real economies over the asymmetric information issue. Asymmetric information means that investors cannot easily determine the actual level of risk associated with their investment. As a consequence of the existence of asymmetric information, managers have more information about the company's operations and financial situation than current and potential investors. Inadequate information places all investors at a disadvantageous position because managers may have different goals and may use the company resources for their own purposes and not necessarily for the promotion of the investors' interests.

The result of asymmetric information is that investors must rely on managers to act in the company's best interest. Besides, foreign investors are at an informational disadvantage compared to domestic ones.² When investors are lacking sufficient information on equities, information flows become important determinants of foreign

¹ Witold J. Henisz and Jonathan Story, 'Corporate Risk Assessment and Business Strategy' in Peter K. Cornelius and Bruce Kogut (edn.) *Corporate Governance and Capital Flows in a Global Economy* (OUP, 2003), 221.

² Stijn Van Nieuwerburgh and Laura Veldkamp, 'Information Immobility and the Home Bias Puzzle' (2009) 64(3) *The Journal of Finance* 1187, 1187-1188.

investment.³ Without a structured system of disclosure and, in particular, financial reporting, it is very difficult for foreign investors to obtain timely, consistent, accurate and reliable information on their investee companies. Therefore, it is not surprising that foreign investors place great emphasis on corporate governance, because they need to know ‘hows’ and ‘whys’ of the corporation they invest, in order to understand its prospects and minimise all potential problems.

Shleifer and Vishny state that ‘corporate governance deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investment’.⁴ It provides the structure through which the objectives of the company are set; the procedure for attaining those objectives; and the process through which the monitoring of management is determined and aligns the interests of managers and investors. It ensures transparency, fairness and accountability and increases trust in the investment environment. When this trust is undermined, investors lose their interest for risk.⁵ Corporate governance is designed to provide investors with assurances that the capital they have invested in companies is being used for appropriate purposes, mostly profit-making ones.⁶

As discussed in Chapter 2, the dilemma of corporate governance is who controls management under dispersed ownership. Since shareholders’ are the residual claimants of profit, they should have the right to monitor management. It is reasonable

³ Richard Portes and Helene Rey, ‘The Determinants of Cross-Border Equity Flows’ (2005) 65(2) *Journal of International Economics* 269, 288-289.

⁴ Andrei Shleifer and Robert W. Vishny, ‘A Survey Of Corporate Governance’ (1997) 52(2) *Journal of Finance* 737, 737. See also Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, ‘Investor Protection and Corporate Governance’ (2000) 58 *Journal of Financial Economics* 3, 4 and Benjamin E. Hermalin, ‘Corporate Governance’ in Robert Gibbons and John Roberts (eds.), *The Handbook of Organizational Economics* (Princeton University Press, 2013), 734.

⁵ Bill Witherell, ‘Corporate Governance and Responsibility Foundations of Market Integrity’ (2002) OECD Observer No. 234, <http://www.oecd.org/daf/inv/corporateresponsibility/1840502.pdf> accessed on 25 June 2015

⁶ Ira M. Millstein and Holly J. Gregory, ‘Corporate Governance Reform: Learning from our Mistakes’ in Cornelius and Kogut (n. 1) 491-492.

for investors in publicly traded companies to demand corporate governance mechanisms that will monitor the management of capital they provided. However, this dilemma disappears in companies where ownership is concentrated in the hands of a few shareholders. In such an environment, the problem shifts from the ‘unrestrained’ managers to the minority investors expropriated by controlling shareholders.

Ownership concentration has been acknowledged as an important means of minimising agency problems and improving investor protection.⁷ However, such a concentration can have negative effects. In concentrated ownership structures, controlling shareholder obtain controlling power by pyramidal ownership. As professional managers are hired by controlling family, the managers who have specific knowledge about the company may act for the benefits of family members, but not for the all shareholders. Without strong legal protection for minority investors, controlling investors may misuse company assets and engage in self-dealing practices to the detriment of the company and its other investors. It becomes difficult to attract equity capital when practices, such as transfer pricing and tunnelling, take place. This is where corporate governance becomes of critical importance.

This Thesis has examined two main questions. Firstly, it has considered whether corporate governance is a determining factor in attracting foreign equity investors to the Turkish capital market. Secondly, it has analysed which novelties of the new TCC regarding corporate governance have an effect on the perception of foreign investors. The findings support the argument that foreign investors prefer to invest more in companies with good corporate governance.⁸ Thus, corporate governance plays a key

⁷ Shleifer and Vishny (n. 4), 753-755.

⁸ Reena Aggarwal, Leora Klapper, Peter D. Wysocki, ‘Portfolio Preferences of Foreign Institutional Investors’ (2005) 29(12) *Journal of Banking and Finance* 2919, 2932, Miguel A. Ferreira, Pedro P. Matos, ‘The Colours of Investors’ *Money: Which Firms Attract Institutional Investors From Around*

role in the perception of foreign investors, as it is evident that foreign investors do prefer companies with good corporate governance structures. Previous research indicates that information asymmetry between insiders and investors can be minimised by increased transparency.⁹ The results of this Thesis match those observed in earlier studies. The results show that the novelties of the TCC facilitate information gathering, and thus, despite its flaws, has had a positive effect on the notion of investor perception.

1. Corporate governance as a factor for attracting foreign equity investors to the Turkish capital market

The analysis has shown that, even though the internalization of cross-border portfolio investments has resulted in a dramatic increase in international capital flows in the last two decades, the ability of Turkey to attract foreign capital has been limited. The determinants of the level of foreign equity inflows are closely related to the perception of economic stability and political environment. The poor performance of the Turkish equity market, which has often been attributed to political and economic uncertainty and a high degree of volatility underpinned by recurrent economic crises, made the economic situation of the market less predictable and riskier for foreign investors. The capital market was characterised by low liquidity and high volatility.¹⁰ At the same time, macroeconomic instability undermined the credibility of the state and corporations opted for low-quality corporate governance practices as they saw these

the World?’ (2008) 88(3) *Journal of Financial Economics* 499 – 533 and Praveen Das, ‘The Role of Corporate Governance in Foreign Investments’ (2014) 24(3) *Applied Financial Economics*, 187-201 are examples of research that support foreign investors prefer to invest more in companies with good corporate governance

⁹ Robert C. Merton, ‘A Simple Model of Capital Market Equilibrium with Incomplete Information’ (1987), 42 (3) *Journal of Finance* 383, 506-507, See also Douglas W. Diamond and Robert E. Verrecchia, ‘Disclosure, Liquidity, and the Cost of Capital’ (1991) 66 (4) *Journal of Finance* 1325–1355

¹⁰ Melsa Ararat and Mehmet Uğur, ‘The Turkish National System of Corporate Governance’ in Ahmed Narici (ed.) *Corporate Governance Around the World* (Routledge, 2008), 259.

practices as an additional burden.¹¹ Due to cultural reasons and regulatory deficiencies, as discussed in previous chapters, the level of transparency in Turkish companies has remained low, financial reporting has remained opaque, disclosure has been limited, pyramidal structures have encouraged the proliferation of business groups, and boards continue to be dominated by insider owners.

Without effective transparency and proper disclosure mechanisms, investors are not able to assess how and in what manner a company is being managed, and hence accountability does not exist in any meaningful way. These factors weakened investor confidence in the Turkish market and caused the share of foreign investments to remain low in relation to Turkey's economic fundamentals. Shortcomings in the legal and regulatory framework contributed substantially to the risks of investing in equity markets in Turkey. Foreign investors' interest in the Turkish capital market remained particularly weak.¹² These deficiencies adversely affected not only the development of an equity market into which both foreign and domestic savings could be channelled, but also the flow of foreign equity investments.

As indicated in Chapter 2, macroeconomic instability and poor transparency and accountability resulted inevitably from the heavy involvement of the Turkish state in the economy. The state's heavy involvement fostered non-transparent links between the state and capital owners which led to the creation of family business groups. The creation of these business groups resulted in the persistence of a controlling minority

¹¹ Ibid at 260.

¹² Melsa Ararat and Mehmet Uğur, 'Turkey, Corporate Governance at the Crossroads' in Christine A. Mallin (ed.) *Handbook on International Corporate Governance Country Analyses* (Edward Elgar Publishing, 2006), 193-194.

structure, cross-ownership and privileged ownership structures. These links inhibited the delegation of control to professional management.¹³

Family-owned companies have long been the backbone of the Turkish economy. It is a fact that the managers are also the controlling shareholder in most Turkish companies. Contrary to the assumption that concentrated ownership leads to better corporate governance because an owner, who also manages the company, is more likely to reduce agency problems, the Turkish case shows that being family-owned does not make these companies immune from the problems associated with asymmetric information and corporate governance.

Moreover, the state's protectionist attitude towards foreign transactions in the market inhibited the improvement of both the capital market and its regulatory framework for encouraging foreign investment.¹⁴ As the activities of foreign investors were largely restricted, the need for legislation to ensure that investors enjoy a reliable and transparent investment environment, which could provide them with protection, did not arise until the early 1990s.

Turkey has been slow to develop and fully enforce transparency, disclosure and accountability. This legal and cultural infrastructure seems to be an important factor in the historic difficulty that Turkish firms have had in attracting foreign capital. However, it can be stated that the post-2003 reforms and changes in the legal and regulatory framework constitute significant steps towards the establishment of an effective capital market. Corporate governance is the principal means by which companies can become transparent and accountable to all investors. Improvements in corporate governance result in improvements in transparency and accountability.

¹³ See Chapter 2 Section 3.1 pg. 75

¹⁴ See Chapter 1 Section 4 pg. 37

Improved corporate governance reduces agency costs as better information flows from the company to the investors.

The first aim of this Thesis was to examine whether corporate governance is a determinant in attracting foreign investors to the Turkish capital market. The data provided in Chapter 4 (Table 1) indicates that it is a crucial one. Investors take corporate transparency and accountability into serious account because they need regular and reliable information about companies. However, many investors face difficulties in gathering such reliable information. Corporate governance closes this information gap. The BIST-Corporate Governance Index has a positive effect on improving the quality of the regulatory framework. Therefore, it has the potential to positively influence corporate behaviour. Even though only 13% of all listed companies are listed in the BIST-Corporate Governance Index, approximately half of foreign investors trading in Borsa Istanbul invest in companies in this index. The high number of foreign investors in the BIST-Corporate Governance Index indicates that good corporate governance practices in companies listed in this index reflect the preference of foreign investors. Thus, properly implementing corporate governance principles makes a difference in attracting foreign investors.

The high percentage of foreign investors in the BIST-Corporate Governance Index points to the fact that these investors do value companies that place an emphasis on corporate governance. A great deal of previous research has revealed that information asymmetry plays an important role in foreign investment decisions.¹⁵ Foreign investors are located too far away from the companies to obtain information and reduce their risk before making a decision. Transparency and disclosure become essential elements to assess the risk of investment as these two provide the basis for

¹⁵ See Chapter 1 Section 6 pg. 46

informed decision-making by existing and potential investors.¹⁶ Therefore, they prefer those aspects of corporate governance that facilitate information gathering and reduction of risk. Consistent with this argument, the data indicate that a foreign investment decision in the Turkish capital market is affected by good corporate governance. The rationale is that poor corporate governance is viewed as risky, whereas foreign investors view good corporate governance as a sign of strength in a corporation. Foreign investors are demanding better financial reporting and corporate transparency in order to counter their uncertainty about investment decisions. Thus, corporations that provide timely, consistent and accurate information to their investors attract more foreign investors. Consequently, it is proposed that companies that aim to attract foreign investors should put emphasis on improving their corporate governance practices.

Information asymmetry poses unforeseen risks.¹⁷ The role of corporate governance is, therefore, crucial in lowering the risks. Investors need to be careful though because corporate governance mechanisms and their implementation may differ from country to country depending on economic position, and political and cultural issues. Turkey has followed the OECD model of corporate governance. This model of corporate governance is more suitable for companies with a widespread shareholding structure in sophisticated capital markets, in which firm activities are financed by issuing shares. In contrast, in Turkey the ownership structure is concentrated and firm activities are financed through private equity or bank credits.¹⁸ Taken together, this

¹⁶ Benjamin Fung, 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) 2(2) *Universal Journal of Management* 72, 79

¹⁷ International Finance Corporation, 'Raising the Bar on Corporate Governance: A Study of Eight Stock Exchange Indices' (2013), http://www.ifc.org/wps/wcm/connect/a6724900400aca13af3aff23ff966f85/Raising_the_bar_on_CG.pdf?MOD=AJPERES accessed on 08 June 2015, 23

¹⁸ See Chapter 3 Section 1.1 pg. 95

suggests that the pattern of corporate ownership and institutional norms were ignored when the adoption of the OECD principles was decided. Even though the adoption of the OECD corporate governance principles was supported by the IMF and the EU for increasing foreign capital flows in the long term as it was specified in Chapter 3, many of the adopted practices have proved unsuitable for the Turkish business environment. To establish a better investment environment, the demand for corporate governance should come from within the companies rather than be imposed upon them using legislation. Instead, it came neither from the private sector nor investors, but from external sources.¹⁹ Besides, almost 99% of the companies in Turkey are SMEs, which made it very difficult to impose corporate governance standards designed for different type of companies. The Capital Markets Board Corporate Governance Principles are also based on a ‘comply or explain’ approach so it is not easy to compel companies to apply these principles either. Further, companies often tend to explain non-compliance by taking advantage of the absence of a method to verify the accuracy of their explanations.²⁰ Thus, it is clear that the corporate governance code of the CMB was never going to offer a solution for the low level of transparency of companies. Even though the CMB states very clearly that the voluntary nature of the principles should not be taken lightly, companies were neither incited nor mandated to apply its provisions properly.

The Turkish investment environment has long been lacking transparency and effective minority investor protection. The level of accountability is low and obtaining information is difficult for foreign investors. In addition, the ownership structure of Turkish companies can also constitute a hurdle that dissuades foreign investors from potential investments. For these reasons, corporate governance matters for both

¹⁹ See Chapter 3 Section 1.2 pg. 100

²⁰ See Chapter 4 Section 1.2 pg. 154

domestic and foreign investors, who demand a transparent regime, in order to effectively exercise their rights. The Capital Markets Board Corporate Governance Principles, which was supposed to ensure a better investment environment for investors, failed to bring the expected results. Even today, after all the reforms and improvements in the regulatory framework and the economy, the percentage of foreign investors is very low in Borsa Istanbul.²¹

The BIST-Corporate Governance Index has a significant reputational benefit to offer for listed companies. In general, companies included in the BIST-Corporate Governance Index are in a better position regarding corporate governance.²² For foreign investors, information on company governance is valuable. The BIST-Corporate Governance Index not only enables investors to monitor the compliance level of companies with corporate governance principles, but also offers a solution to the abovementioned shortcomings of the corporate governance system, such as the lack of shareholder protection and poor corporate disclosure. Table 1 in Chapter 4 shows that companies listed in the BIST-Corporate Governance Index differentiate themselves by the level of foreign investment they attract. The number of foreign investors invested in the BIST-Corporate Governance Index indicates that corporate governance index is a useful tool for raising investors' trust by increasing transparency and accountability of companies. Thus, it is clear that corporate governance has become a deciding criterion for foreign investors.

²¹ By the end of 2014, foreign investors represent 1% of the total investors in Borsa Istanbul. See Central Registry Agency, Borsa Istanbul Trends Report Volume 11: January – December 2014, 13.

²² Yusuf Mugaloğlu and Eser Erdağ, 'Corporate Governance, Transparency and Stock Return Volatility: Empirical Evidence from the Istanbul Stock Exchange' (2013) 3(4) Journal of Applied Economics and Business Research 207,208. See also Table 6 in Namli Caliskan and Turan Icke, 'Turkish Corporate Governance Principles and its Implications for ISE Corporate Governance Index Companies' (2011) 11(1) Journal of Accounting and Finance 60, 69-70.

2. The effect of improvements to corporate governance in the new TCC on the perception of foreign

Turkey's account deficit is large and the domestic saving rate is low. As discussed in Chapter 1, foreign equity investment plays a critical role in meeting saving deficits and sustaining growth in the Turkish economy.²³ The data clearly suggests that the expectations of foreign equity investors are not met by the current Turkish capital market. Deficiencies in the legal framework and regulatory approach contribute significantly to the risks of investing in the Turkish equity market. Turkey needs to improve its regulatory framework in order to change the perception of foreign investors and increase the foreign capital influx. It has been shown that, even though the Capital Markets Board Corporate Governance Principles came into effect in 2003, underdeveloped corporate culture hampered the efficiency in transition to corporate governance. Corporate governance has not been popular as an addition to the business culture of Turkey. Thus, it has not been sufficient to provide a secure and reliable investment environment to foreign investors. Attempts have been made in recent years to reinforce the implementation of corporate governance principles, the most notable of which is through the new TCC. The increase in the number of foreign investors suggests that corporate governance novelties of the new TCC become more successful compared to the previous code.

The idea of corporate governance, which lies in the core of the new TCC, aims to overcome the shortcomings of the Turkish business environment. One of the main objectives of the new TCC is to create an infrastructure based on transparency and oversight over management. The voluntary approach to corporate governance has

²³ See Chapter 1 Section 5 pg. 41

failed to provide foreign investors with protection. In addition, the soft law nature of the principles constituted an obstacle to implement sanctions such as fines and injunctions. The lesson that is drawn from the Turkish experience is that with voluntary enforcement, the large part of business community did not comply and the principles ended up being ineffective. The potential for abuse was a real problem as voluntary compliance lacks legitimacy. On the other hand, private enforcement could not improve the corporate governance culture either, because monitoring was relatively weak and costly for minority investors. As it was proposed in chapter 4, legislative regulation of corporate governance can rightly be justified because it is clear that ‘comply or explain’ as an enforcement method did not address the implementation problem of Turkish companies. Under the Turkish business culture, public enforcement will provide more effective protection to investors, as there are legal sanctions. Therefore, public enforcement is necessary to ensure the minimum level of corporate governance standards through the imposition of sanctions wherever necessary.

Mandatory enforcement of corporate governance is justified where rules are likely to affect investors especially where potential for abuse or opportunities for dishonesty exist.²⁴ With the new TCC, the legislator has used the law to make corporate governance much more of a legal obligation because it was evident that hard law is more likely to be effective in the Turkish business culture. The President of the TCC Commission stated that ‘corporate governance principles are no soft law anymore’, referring to the Article 375 and 1524 of the new TCC.²⁵ In addition to the President’s

²⁴ Anthony Ogus, ‘Rethinking Self-Regulation’ (1995) 15 Oxford Journal of Legal Studies 97, 98-99.

²⁵ Ünal Tekinalp, ‘Türk Ticaret Kanunu Tasarısının Sermaye Piyasasına ve Sermaye Piyasası Kanununa İlişkin Hükümleri’ (Provisions of the new Turkish Commercial Law on the Capital Market and Capital Market Law) in Korkut Özkorkut, *Impacts of the Draft Turkish Commercial Code on Capital Markets from an EU Perspective* (Banka ve Ticaret Hukuku Araştırma Enstitüsü, 2010), 30.

view, Article 340 can be referred to show the binding nature of the TCC regarding corporate governance. The Article 340 states that ‘the articles of association may be differenced form the Articles of the new TCC on Public Limited Company, provided that the new TCC itself provides so’.²⁶ As a result of mandatory provisions, most corporate governance related issues will be enforced as an obligation of the new TCC. It is a fact that there is still a significant majority shareholder influence in corporate governance of Turkish companies. However, other shareholders are not as weak as they were before the enactment of the new TCC against the controlling shareholder. This is a consequence of Article 340 which disables controlling shareholders to increase their power by eliminating provisions that make them less effective. Therefore, after the new TCC was enacted, soft law met hard law. The new TCC goes beyond a voluntary approach in respect of corporate governance. This makes it possible for companies to mix voluntary and obligatory corporate governance to make themselves more attractive for investors. In this way, an adequate legal framework for compliance in the area of corporate governance was established.

It is argued in previous chapters that law on the books does not always prove to be sufficient for the protection accorded to investors. The goal of corporate governance practices covered by the new TCC is to establish a set of rules to protect investors. Alongside this purpose, stringent rules concerning expropriation have been established. Stringent rules on transparency and disclosure put investors in a comparatively better position to assess their investment opportunities. In addition to this, the concept of ‘expropriation’ has been expanded. Some of the provisions aim to limit the subjective and arbitrary decisions and practices of the controlling

²⁶ The Republic of Turkey Turkish Commercial Code Law No. 6102 (31 January 2011), < <http://www.tbmm.gov.tr/kanunlar/k6102.html> Article 340

shareholder in joint-stock companies.²⁷ To start with, preference shares are of great importance because in comparison to the ordinary shares, they provide wider rights to investors. The New TCC regulates the voting rights of preference shares under a special provision. There was not any limitation to the number of votes that can be casted for per share in the previous TCC. Whereas pursuant to Article 479/2 of the New TCC, the maximum number of voting rights that can be given to a privileged share is limited. This upper limit for the voting rights has been recently introduced to the Turkish legal system. Even though this limitation has some exceptions, it provides more protection to investors from misuse of such rights. In the struggle between controlling shareholders and minority interests, the balance of power has started to shift. For the first time under Turkish Law, Article 358 of the new TCC brings prohibition on loans to the shareholders by the company. The unlimited borrowing power of shareholders has been limited to some extent. According to Article 358 TCC, it is lawful that controlling shareholders borrow from the company until they fulfil their due debts. Failure to comply can result in the imposition of sanctions. This Article significantly limits the activities of controlling shareholders. It prevents the misuse of the resources of the company by controlling shareholders regarding their personal expenses. Weakening the control power of dominant shareholders over companies is an important step for improving the corporate governance framework in the Turkish business culture. The early risk identification committees have been introduced into Turkish commercial law.

This committee ensures the management of the risks that would endanger the existence, development and continuity of the company. However, the New TCC does

²⁷ See Chapter 3 Section 3 pg. 126 for the other corporate governance related novelties of the new Commercial Code

not determine any specific criterion regarding the composition of the committee.²⁸ Despite its deficiencies, a mechanism, designed to highlight the risks of a company, offer remedies for these risks and report them to the public, will be very helpful in reducing the investment risk for foreign investors. This legislation places major restrictions on the controlling shareholders who can directly or indirectly expropriate the rights of investors.

As shown in Chapter 4, scholars have acknowledged that publicly traded companies under-report information without legal sanctions. Mandatory disclosure standardizes the format and quality of the information disclosed. This improves comparability of information. Thus, the value of information increases.²⁹ For this reason, mandatory disclosure is one of the most important means to protect investors. Investors demand transparency and disclosure not only to better exercise their rights, but also to reduce their monitoring costs. Investors might not discover related party transactions if companies were not required to disclose these transactions. Therefore, tying mandatory disclosure to legal liability is necessary to reassure investors about credibility and quality of information.

Corporate governance under the new TCC places a great emphasis on transparency and disclosure through the imposition of legal liabilities and penalties for non-compliance.³⁰ Under the previous TCC, rules regarding the investors' information rights were not properly applied. The TCC expands the scope of the information obtaining right in a manner that restricts the exceptions solely to commercial secrets

²⁸ The new TCC No. 6102 (n. 26) Article 378, See also Ceyhun Necati Pehlivan, 'The New Turkish Commercial Code: Major Corporate Law Reform in Line with EU and Swiss Law' (2013) *International Company and Commercial Law Review* 68, 68-69

²⁹ Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry B. Hansmann, Gérard Hertig, Klaus J. Hopt, Hideki Kanda, and Edward B. Rock (eds.), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP, 2009) 280.

³⁰ See Chapter 4 Section 2 pg. 161 for discussion of related Articles of the New TCC

and company benefits. The right to obtain information is regulated in Article 437 of the new TCC. Article 437 of the new TCC requires a group of companies to disclose information about their affiliates. Obviously, this Article means that investors become able to obtain information regarding the companies and their affiliates in an active way. Transactions between the parent and the affiliate companies become transparent to all investors. Investors of the parent company become entitled to request information on the financial status of affiliate companies at the general assembly meetings of the parent company. Thus, transparency and accountability has improved in the investment environment. With the new TCC, the relations between the parent company and its affiliates are regulated from an investor protection perspective. Article 437 also provides equal treatment to all investors regarding the right to obtain information which prevents discrimination between majority and minority investors. Such a development is beneficial for all investors as it gives them an appropriate understanding of their investment and greater flexibility to exercise more scrutiny over the company operations to protect themselves against losses. More crucially, investors have been given a standing to sue. Thus, the right to obtain information is guaranteed through litigation. As far as investors are concerned, the scope of application of their right to information has been expanded. This is an important rule that strengthens investors because information asymmetry between investors and controlling shareholders has been reduced.

Auditing is one of the most important tools for investors to assess the operations of the company that they want to invest in. In Turkish companies, where the owner and the manager usually belong to the same family, auditors' assurances on financial statements play a significant role, especially for minority shareholders and their investments. Article 438 states that 'every shareholder has the right to request the

appointment of a special auditor whenever it is necessary to exercise their shareholder rights in the general assembly meeting, even if it is not scheduled in the general assembly agenda, and provided that the information or evaluation right has already been exercised'.³¹ The right to request special audit is a significant innovation in the new TCC which reduces the concern of investors about mismanagement of the company. The enforcement of the new TCC provided new instruments to shareholders to exercise their shareholder rights in the company. This Article increases the reliability, objectivity and level of transparency in corporations as well as protects minority interests against controlling shareholders within the company.

The new Code adopted a different system from the previous Code and group of companies are now also being regulated. In order to provide fairness, Article 202 illustrates the conditions of abuse of dominance through transactions. The concept of 'dominance' is one of the novelties of the new TCC. Article 195 of the new TCC lists the sources of dominant power in detail.³² Accordingly, a parent company may not direct the affiliate to carry out legal transactions such as its business, assets, funds, staff which would negatively affect the affiliate's efficiency without any reasonable grounds. In other words, parent companies cannot use control over their affiliates using their influence. The Article does not prohibit the transfer of resources within groups of companies. However, it mandates disclosure of the transactions in order to make these actions transparent to all investors. If a loss occurs to an affiliate company as a result of the actions of the parent company, the parent company is obliged to compensate for the loss. Article 202 brings a new dimension to liability under Turkish law as it states that 'a "dominant company" shall not exercise control on the "affiliate

³¹ The new TCC No. 6102 (n. 26) Article 438

³² Ibid Article 195

company” in a sense that would cause to incur losses for the latter’.³³ It foresees indemnification of loss. The lawmaker uses the term ‘loss’ instead of ‘damage’ in the Article 202 because loss is understood includes damages as well as decrease in the value of assets in the sense of the new TCC. This provision closes an important gap that existed under the previous code. Even though the interpretation of these terms can be an issue of concern, as discussed before, it is an important reform for investors because it regulates the liability of controlling company within groups of companies for the protection of investors.

To reduce the possibility of controlling shareholders abusing their position through the parent company, Article 199 of the TCC clearly states that the parent companies are required to disclose an annual ‘affiliation report’, which shows the scale of the relationship between parent and affiliate companies. The affiliation reports are of significant importance with regards to the information obtaining rights of the shareholders. This report helps shareholders to understand the economic side of the legal transactions. Thus, as per stated in Article 199(2) the affiliation report should be prepared in accordance with the true and fair view principle.³⁴ Judicial fines will be imposed in the event of violation of this Article. Thus, the right of investors to obtain information on the financial situation of affiliated companies has been extended. These novelties have been especially useful in reducing the time and money spent by foreign investors.

In Turkish corporate culture, where a group of companies usually belong to a family or a few controlling shareholders, the affiliate companies cannot act as an independent business. In order to protect the benefits of the group, the affiliate companies have to

³³ Ibid Article 202

³⁴ Ibid Article 199(2)

follow the instructions of the parent company. This increases the expropriation risk of investors. The provisions of the new TCC provide an advanced liability regime for company groups. These novelties of the new TCC prevent and remedy the negative effects of the actions taken by an affiliate company and its investors in accordance to the instructions given by the parent company.

With the enactment of the new TCC, it became possible for foreign investors to attend general meetings from where they are. The legal basis of electronic general meetings is Article 1527 of the new TCC.³⁵ According to the Article 1527 of the new TCC, in companies which have certain level of technical infrastructure, general meetings can be held electronically. It is pivotal to underline the importance of the legal system embracing the technology for foreign investors. Electronic general meetings will save time, money and energy. Besides, voting rights can be exercised via electronic means. In this way, investors, who are not based in the same place with the company, will be able to attend and exercise their rights in a more efficient way. Electronic general meetings are a convenience of the new TCC for investors. Even though the implementation of electronic media usage is considerably new, it will adapt the Turkish legal system to technological innovations. This novelty of the new TCC shows a potential to increase the level of transparency in Turkish companies and will be beneficial for their attractiveness to foreign investors.

According to the findings of this Thesis, even though some further modernisation activities are still necessary, the new TCC is innovative in a number of areas. Overall, with the new TCC, Turkey seems to have taken a major step forward in the area of corporate governance. The data presented in Table 2 in Chapter 4 suggest that there has been a five-fold increase in the number of foreign investors after the enactment of

³⁵ Ibid Article 1527

the new TCC. Thus, this increase further support the idea that the new Code has become a successful tool for ensuring minimum standards of corporate governance and thus attracting foreign investors. However, the investment decision depends on other country specific and external factors as well. Therefore, one can argue that this increase can be attributed to reasons other than the corporate governance regime of the new Code. For instance, underperformance in the world economy was observed across almost all regions in the past two years. The Eurozone is in a prolonged recession. A number of economies, such as Cyprus, Greece and Portugal, have experienced a notable slowdown.³⁶ As risks associated with the economic crisis in the Eurozone increased, international capital flows started to move away. On the other hand, Turkey's comparatively stable economy in the last decade accompanied by its fast economic growth made Turkey an attractive destination for foreign investors.³⁷ Economic growth combined with the regulatory reforms may be contributing factors for international investors to rebalance their portfolios with equities of the Turkish market. In addition, the steady progress on economic growth and political aspect increased the chances of Turkey upgrading its investment grade rating by global credit agencies.³⁸ These indicators put Turkey forward as a secure place for investment. This has led to the recent increase in foreign capital inflows to the Turkish market.

³⁶ United Nations, 'World Economic Situation and Prospects 2014', 3, http://www.un.org/en/development/desa/policy/wesp/wesp_current/2014Chap1_en.pdf accessed on 07 June 2015

³⁷ General Directorate of Revenue Policies, 'Data on Growth and GDP' <http://www.gep.gov.tr/web/RUlusai.aspx?prmts=214> accessed on 05 June 2015

³⁸ The investment grade of Turkey upgraded to 'investable' by Standard & Poor in 2011. See 'Standard & Poor's Upgrades Turkey To Investable' *Hürriyet Daily News*, 21 September 2011 < <http://www.hurriyetdailynews.com/default.aspx?pageid=438&n=standard--poor8217s-upgrades-turkey-to-investable-2011-09-21> > accessed 05 June 2015. Similarly Moody's graded Turkey as "investable" in 2013: See 'Türkiye Süper Lige Girdi' (Turkey Entered the Super League) *HaberTürk*, 16 March 2013 < <http://ekonomi.haberturk.com/ekonomi/haber/845048-turkiye-super-lige-girdi> > accessed on 05 June 2015

The position taken in this Thesis is that economic growth is an important, but not a sufficient on its own, factor to attract foreign investors. If this was the case, the number of foreign investors would be much higher in 2010, a year in which economic growth was around 2 times greater than in 2013; yet this is not the case. Foreign investors wish to increase their returns as well as reduce risks and costs of their investment. Economic growth is a significant factor that increases the return of investments. However, an uncertain and risky investment environment would reduce the returns. Therefore, economic growth is a significant factor only when taken with other factors that reduce the risks of investment. For this reason, the rate of economic growth is not enough to explain the sudden increase in the number of foreign investors.

On the other hand, it is possible that the global economic crisis became a significant factor that channelled foreign investors into the Turkish market. However, provided that investment environment is not reliable, foreign investors definitely prefer other stock markets instead of the Turkish one. The examination of corporate governance in the Turkish business environment shows that the lack of a legal foundation was the main obstacle in increasing the efficiency of the Code. The rule-based approach to corporate governance was redefined by the new TCC and mandated the corporate sector to upgrade its corporate governance practices, enhancing transparency and accountability. It is a vital improvement of corporate governance in Turkey that the new rules protect the interests of foreign investors. More foreign investors preferred the Turkish capital market after the new TCC because it provided a more secure investment environment and encouraged foreign capital influx to Turkey. As it became evident, Turkey's economic stability and legal transformation was warmly welcomed by foreign investors.

One can also argue that what attracted foreign investors to the Turkish capital market after the enactment of the new TCC was not the improvements to the regulatory framework, but instead the novelties of the new Code. In other words, the sudden increase can be explained by the curiosity that investors had. Again, if this was the case there would be a reduction in the number of foreign investors after the law had been enacted for a specific period of time. It is, of course, not logical to expect an infinite increase in the number of foreign investors. However, the number of investors would gradually rise if the sudden increase was attributed to the improvement of the law. The Reports of the Turkish Investor Relations Association and Central Registry Agency in September 2014 and December 2014 show that the number of foreign investors is increasing at a slowing rate.³⁹ This shows that foreign investors did not immediately value the novelties of the TCC but they did welcome them.

In summary, it is certainly true that corporate governance does not constitute the main factor that investors take into account when choosing to invest in a Turkish company. In such a case, the company with the highest governance standards would be the one that attracts the most foreign investment; yet this is not the case. Other company and country specific factors, besides external factors, are at work to affect the sentiment of foreign investors. Nevertheless, the importance of corporate governance must not be understated. Examining the data given in Table 1 and Table 2 in Chapter 4, one can notice that generally companies with good corporate governance attract foreign

³⁹ The Report has been prepared by The Turkish Investor Relations Association and Central Registry Agency (CRA), using CRA's database. See CRA https://www.mkk.com.tr/project/MKK_EN/file/content/Information%20Center%2FExchange%20Trends%20Report%2FBIST_Trends_Report_X , 13 accessed on 27 June 2015 for number of foreign investors in September 2014 and CRA, https://www.mkk.com.tr/project/MKK_EN/file/content/Information%20Center%2FExchange%20Trends%20Report%2FBIST%20Trends%20Report%20XI , 15 accessed on 27 June 2015 for number of foreign investors in December 2014

investment. Hence, corporate governance does remain an important factor in investors' consideration in the foreign equity investment decision in the Turkish capital market. The corporate governance regime under the new TCC became a successful means of improving transparency and accountability in the business environment. The significant increase in the number of investors after the enactment of the TCC illustrates that, despite its shortcomings, the rights given to investors by the new law have been effective in changing the risk perception of foreign investors about the Turkish market. It is proposed that the legitimation of these rights has been widely seen as a positive development by foreign investors.

It is appropriate to conclude with a quote from Arthur Levitt, former U.S. Securities and Exchange Commission chairman, who sums up succinctly the importance of the relationship between good corporate governance, transparency, accountability and the consequent impact on foreign equity investment:

'If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country-regardless of how steadfast a particular company's practices may be suffer the consequences'.⁴⁰

⁴⁰ Arthur Levitt, 'Speech by SEC Chairman: Remarks Before the Conference on the Rise and Effectiveness of New Corporate Governance Standards', New York, December 2000 < <https://www.sec.gov/news/speech/spch449.htm>> accessed on 16 June 2015

Appendix

2009-2013 BIST CORPORATE GOVERNANCE INDEX			
Year/Month	Index	Nationality of Investor	Number of Investors in Current Period
December 2010	BIST-Corporate Governance	Domestic	390,010
	BIST-Corporate Governance	Foreign	3,582
	BIST-Corporate Governance	All	393,592
December 2011	BIST-Corporate Governance	Domestic	419,674
	BIST-Corporate Governance	Foreign	3,969
	BIST-Corporate Governance	All	423,643
December 2012	BIST-Corporate Governance	Domestic	434,607
	BIST-Corporate Governance	Foreign	4,431
	BIST-Corporate Governance	All	439,038
December 2013	BIST-Corporate Governance	Domestic	460,931
	BIST-Corporate Governance	Foreign	4,771
	BIST-Corporate Governance	All	465,702

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