Does Macroeconomic Performance Affect Corporate Governance? Evidence from Turkey

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Recent work on corporate governance has highlighted the effects of corporate governance quality on macroeconomic crises, especially in the context of South-East Asian economies. However, the possibility of reverse causation from macroeconomic performance to corporate governance has been overlooked. This paper aims to address this issue by examining the relationship between macroeconomic stabilisation and corporate governance reforms in Turkey since the 1999 and 2001 crises. We demonstrate that the prospect of macroeconomic stability has led to extensive corporate governance reforms for two reasons. First, recent return to macroeconomic stability has been underpinned by public governance reforms, which spilled over to the area of corporate governance. We call this the statutory reform effect. Second, macroeconomic stability tended to have a positive effect on firms' investment in corporate governance quality. We call this the voluntary reform effect. To substantiate these findings, we examine the post-1999 developments in the following areas: (i) the effectiveness of regulatory authorities; (ii) disclosure and transparency rules; and (iii) the quality of the enforcement regime.

Keywords: Corporate governance, institutional quality, macroeconomic stability, Turkey

Introduction

The debate on the relationship between corporate governance and macroeconomic performance is a fairly recent one. It emerged in the context of the South-East Asian crisis and was geared towards discussing the impact of poor corporate governance (CG) quality on the crisis in Japan and other countries. Studies focusing on Japan argue that economic stagnation in that country has been due to weaknesses in the Japanese CG regime, which made the economy vulnerable to adverse shocks. Specifically, it is argued that the financial keiretsu system led to misallocation of capital and plunged Japan into excess capacity and liquidity problems (Morck and Nakamura, 1999). Studies focusing on countries with a pegged exchange rate regime, on the other hand, have discovered that weak CG regimes have typically worsened the currency crises in emerging market economies (Johnson *et al.*, 1999). The effect is explained as follows: The looming crisis led to lower returns on investment. Faced with lower returns, managers were induced to engage in expropriation – which was possible because of poor CG standards. This, in turn, had an adverse effect on investor confidence, leading to massive capital outflows, which eventually led to excessive fall in stock prices and the price of domestic currency. Another study (Castren and Takalo,

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2000), demonstrates that poor CG standards have increased the supply-side rigidities and made a speculative attack more likely.

The innovative approach adopted in these studies has drawn attention to an issue that has been overlooked in the traditional corporate governance literature: the impact of CG standards on macroeconomic volatility. Yet, there is no a priori reason to assume that the causation between CG quality and macroeconomic performance is a one-way process. There may well be a reverse causation from macroeconomic performance to CG quality. In fact, a careful reading of the works cited above suggests that this is the case. In Johnson *et al.*, the trigger for the crisis is not poor CG quality per se, but the onset of falling returns on investment that, under poor CG standards, has made tunnelling activities both necessary and feasible. In other words, the starting point in the chain of causation between the macroeconomic environment and CG quality is the falling rate of returns – an outcome closely related to the macroeconomic environment.

In Castren and Takalo, on the other hand, poor CG quality does increase the risk of macroeconomic instability, but there is no reason as to why the macroeconomic environment should not affect the observed level of CG quality in the first instance. In fact, this possibility is accepted implicitly by Castern and Takalo when they state that, under credit constraints, CG reforms may be counter-productive. Under severe credit constraints, CG reforms may be counter-productive because they may lead to a "financial accelerator effect" that may worsen the financial crisis. In other words, under certain macroeconomic conditions that generate credit constraints both corporate actors and public policy-makers may refrain from CG reforms.

To put it bluntly, even though CG quality can affect macroeconomic outcomes, the macroeconomic environment itself can also affect CG quality in emerging markets. We think this type of reverse effect has been at play in Turkey in the 1990s and in recent years. In other words, we think that the macroeconomic instability of the 1990s was associated with low CG quality, whereas the return to macroeconomic stability after 2001 has been conducive to noticeable improvement in the quality of Turkey's CG regime. To demonstrate this effect, we proceed as follows. In the following section, we first highlight the causes and levels of macroeconomic instability in the 1990s and elaborate on its likely effects on CG quality. We then examine the transition to a rule-based macroeconomic policy framework with a view to identifying the scope for economic stability and the likely impacts of the latter on CG reforms. The next section examines recent CG reforms in three areas: (i) emergence of regulatory authorities; (ii) change in disclosure and transparency rules; and (iii) change in the quality of the enforcement regime. We demonstrate that the onset of macroeconomic stability has been associated with visible improvements in Turkey's CG regime. Finally, we conclude by arguing that CG reforms in emerging markets are likely to remain limited and enforcement to be weak until policy-makers establish macroeconomic stability on the basis of a rule-based policy framework and corporate actors consider the new policy framework as credible.

Macroeconomic performance and CG quality in Turkey: the tale of two decades

Throughout the 1980s and 1990s, the Turkish economic policy was characterised by a symbiotic relationship between discretionary policies and rent-seeking behaviour. As a result, Turkey's macroeconomic performance has deteriorated over time and the risks faced by corporate actors have increased. As can be seen from Table 1, the average growth rates have declined from 4.76 percent in the 1970s to 3.93 percent in the 1990s, whereas the coefficient of variation for growth rates has increased from 51 percent to 137 percent over the same period.

The negative impact of volatility on GDP growth is more significant than the negative association reflected in Table 1. According to a recent work by Hnatkovska and Loayza (2005), a one-standard-deviation increase in volatility would lead to lower average per-capita income growth by 0.5–2.2 percentage points – depending on the period of estimation and the regression technique used. When the authors account for simultaneous and reverse causation in the volatility–growth relationship, they find out that, in the 1990s, a one-standard-deviation increase in volatility would lead to a 2.2 percentage-point decrease in the growth rate of per-capita GDP. The authors also report that the negative association between volatility and growth tends to be stronger in countries with weak institutional quality and pro-cyclical fiscal policies. This finding is very significant for Turkey – a country that was characterised by poor institutional quality and fiscal indiscipline throughout the 1990s.[1]

The major cause of the macroeconomic instability that plagued Turkey over the 1990s was excessive discretion in the conduct of fiscal policy. Atiyas and Sayin (1997) confirm that

Table 1: Declining growth rates and increasing volatility in Turkey: decade averages

Decade	1. Average growth (%)	2. Standard deviation	3. Coefficient of variation (%) (2/1) × 100
1970–79	4.76	2.43	51
1980–89	4.04	2.70	67
1990 99	3.93	5.37	137

Note: Calculated from GDP data at 1987 prices.

the high level of discretion that existed in 1980s reached new heights in the 1990s. This high level of discretion led to budgetary fragmentation, which was reflected in the emergence of extra-budgetary funds and off-budget quasi-fiscal activities (Sayistay, 2000). Although some of the extra-budgetary funds were incorporated into the budget in 1993, World Bank (2001) reports that extra-budgetary fund expenditures still amounted to 10 percent of Turkish GNP in 1999. On the other hand, Atiyas and Sayin (1997) state that quasi-fiscal activities amounted to approximately 10 percent of the GNP in the mid-1990s and have benefited rent-seekers organised around distributive policies of the government.

Due to heavy reliance on extra-budgetary arrangements, there has always been a significant discrepancy between total budget deficits and total borrowing. Total net borrowing from 1971 to 1999 was more than twice the total budget deficits recorded over the same period. While recorded budget deficits amounted to US$109 billion, total net borrowing amounted to US$225 billion – leaving a discrepancy of US$116 billion (Sayistay, 2000, p. 12). This result was due to debts incurred for financing off-budget expenditures.

The non-transparent and discretionary budgetary process provided ample scope for moral hazard in public and private economic decisions. For example, the procurement law encouraged the submission of under-priced proposals but failed to limit cost escalation subsequent to project awards. This practice has generated a selection bias that favoured unsophisticated bidders and reduced the efficiency of investment projects (World Bank, 2001). Yet, the most evident indication of moral hazard was the so-called duty losses of public enterprises, especially public banks. Public banks were required to provide subsidised credits to farmers as well as small businesses, in return for a government guarantee that covers any losses incurred. The guarantee was in the form of converting duty losses into government debt, the interest on which was set to cover losses accumulated each year. In effect, the banks were provided with automatic bail out and became increasingly willing to distribute patronage instructed by the politicians. As a result, the *stock* of unpaid duty losses increased from US$1 billion in 1993 to US$19 billion in 1999. The annual *flow* of duty losses also increased from 1 percent of GNP in 1993 to 8 percent of GNP in 1999 (IMF, 2000, p. 13).

The impact of poor public governance standards and the resulting macroeconomic instability on corporate governance quality can be analysed with the help of a model that was developed in Ugur and Ararat (2003). In this model, firms value shareholder loyalty whereas shareholders value corporate governance quality. However, complying with a given set of CG standards involves cost for firms and maintaining loyalty to the firm (i.e. holding on to the firm's shares) involves cost for shareholders. Therefore, firms are motivated to minimise the cost of corporate governance standards and shareholders are motivated to switch loyalty from one firm to the other in order to maximise returns on investment. Given these behavioural assumptions, the firms' and shareholders' reaction functions can be drawn for each level of firm and shareholder commitment. The level of commitment can be measured as a probability ranging from zero to 1. If we assume that shareholder loyalty and corporate governance quality are complementary – i.e. if firms reward an increase in shareholder loyalty by increasing their CG standards or vice versa – the equilibrium levels of shareholder loyalty (L*) and corporate governance quality (Q*) may obtain at point A of Figure 1.

Here R_f and R_s are reaction functions of firms and shareholders at a given probability of commitment. They are positively sloping to reflect complementarity between CG quality and shareholder loyalty. In other words, both firms and shareholders react to each other in the same way. If the firm increases CG quality, shareholders reward the firm by increasing loyalty (or vice versa). Points along R_f represent various combinations of CG quality and shareholder loyalty that enable the firm to derive the same level of marginal benefits.

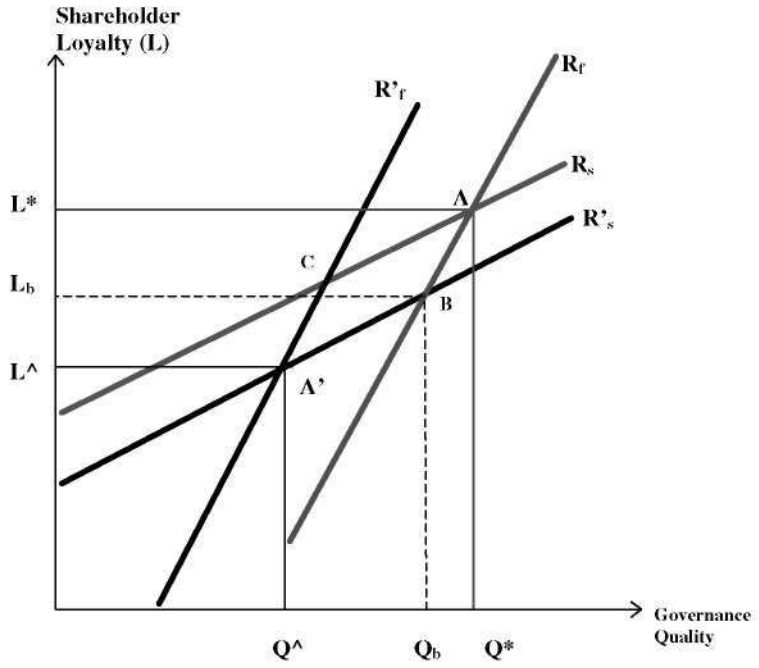

Figure 1: Economic instability lowers CG quality and loyalty: the case of complementarity

Similarly, points along R_s represent the combinations of CG quality and loyalty that enable shareholders to derive the same level of marginal benefits. Hence, point A represents the unique combination of CG quality and loyalty that is acceptable for both the firm and the shareholders. At point A, the equilibrium levels of CG quality and loyalty are Q* and L*.

Now suppose the economy is hit with a crisis, which is likely to have an adverse effect on firm performance. International shareholders will react to the crisis (or to information about its increased probability) by reducing their loyalty to the firm – i.e. by selling their shares and investing in firms in other countries. This move by international investors will lead to a fall in share prices and induce further sales by domestic shareholders. The overall result of these activities is a fall in shareholder loyalty even if the firm maintains the same level of commitment to CG quality. In other words, the shareholders' reaction function (R_s) will shift downward to R's. The new equilibrium is now at point B, where shareholder loyalty (L_b) and CG quality (Q_b) are lower than L* and Q*. This equilibrium, however, is temporary. Faced with fallen shareholder loyalty, the firm will react by reducing its commitment to CG quality. This reaction is represented by a leftward shift of its reaction function (Rf) to R'f – leading to a post-crisis equilibrium at A'. At this equilibrium, shareholder loyalty (L^) and CG quality (Q^) are even lower than previously.

A similar result will obtain even if CG quality and loyalty are substitutes. When CG quality and loyalty are substitutes, firms (or shareholders) free-ride on each other's efforts. When shareholders increase loyalty, firms react by reducing CG quality (or vice versa). This scenario is depicted in Figure 2 below.

In Figure 2, the initial equilibrium is at A – with equilibrium levels of CG quality and shareholder loyalty at Q* and L*. As the economy is hit with a crisis (or as the probability of crisis increases), shareholders reduce loyalty at each level of CG quality. This can be represented by a leftward shift of the R_s to R'_s. As a result, shareholder loyalty falls initially to L_b, but CG quality increases to Q_b. In other words, initially, the firm is forced to increase CG quality in order to offset the effect of falling loyalty. However, this will be costly for the firm, who reacts by reducing its commitment to CG quality. This move is reflected in the leftward shift of the R_f to R'_f. The stable equilibrium will be at point B, where the levels of CG quality (Q^) and shareholder loyalty (L^) are lower than the pre-crisis levels.

In the context of Figures 1 and 2, suppose that the government introduced regulatory reforms that aim to improve CG quality. CG reforms imply that firms are forced to deliver higher CG quality at each level of shareholder loyalty. This can be represented as a rightward shift of their reaction function from R'f to Rf. Then, the initial equilibrium after CG reforms is at point B in both Figures 1 and 2. In both figures, firms incur higher costs as they have to comply with higher statutory CG standards. As far as shareholder loyalty is con-

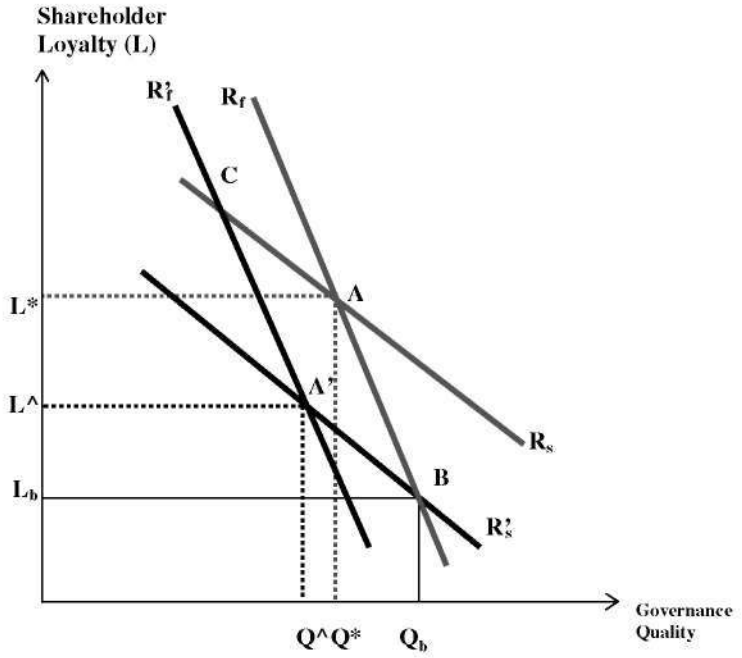

Figure 2: Economic instability lowers CG quality and loyalty: the case of substitution

cerned, we observe that shareholders may either reward the firm by increasing their loyalty from L^ to Lb (Figure 1) or they may free ride on the firm's effort by reducing loyalty from L^ to Lb (Figure 2) – depending on whether CG quality and shareholder loyalty are complementary or substitutes. Compared to the pre-crisis equilibrium at A, neither equilibrium is optimal from the firms' perspective. In Figure 1, the increase in shareholder loyalty from L^ to Lb is not substantial enough to induce firms to remain committed to higher statutory CG standards. In Figure 2, the suboptimality is even more obvious, as shareholders are free riding on the firm's effort to comply with higher statutory CG standards.

Stated differently, statutory CG requirements implied by reforms are not incentive-compatible for the firm. Therefore, in either scenario, the firm will try to deviate from statutory CG requirements through innovative methods. One such method would be to reduce the quality of disclosed information – either by withholding information or by manipulating the information to be disclosed. This is more likely to be the case when ownership is dispersed. Another method would be to engage in tunnelling. This is more likely to be the case when ownership is concentrated. As a result, the firm's statutory reaction function may be at R_f but its *actual* reaction function will gradually shift to the left. The shift may continue until R'_f coincides with the pre-reform function R_f.

The results highlighted above suggest that the macroeconomic volatility experienced in Turkey over the 1990s would have a negative effect on CG quality. This is for three reasons. First, macroeconomic volatility increases the risk associated with investment in listed companies and induces shareholders to switch between shares. In other words, macroeconomic volatility is conducive to lower shareholder (domestic and international investor) loyalty towards companies. Second, macroeconomic volatility increases the risk of a fall in the relative rate of return on investment in the country. This risk induces domestic and foreign shareholders to switch investment to other countries. Finally, as a result of reduced loyalty (or demand for company stock), Turkish firms can be expected to experience a fall in market value. The fall in market value, in turn, reduces the attractiveness of external finance through share issue. Under these conditions, the firm will become less keen to invest in costly CG standards and may in fact be motivated to increase its involvement in expropriation.

This finding is similar to the finding by Doidge *et al.* (2004), who demonstrate that country characteristics that increase the cost of commitment to high CG standards would lead to lower CG standards. In the long-run, it may be in the interests of the firm to commit to high quality CG standards, but in the short-run the cost of such commitment may be too high due to country characteristics – which include the

depth of the financial markets or the level of economic development. Our proposed model extends the range of country characteristics to include the risks implied by discretionary macroeconomic policy that generates excessive fluctuations.

The model above also enables us to identify another obstacle to CG reforms in a highly discretionary macroeconomic policy framework. If the predictions of the model are correct, the policy-maker would be less inclined to introduce higher statutory CG standards for two reasons. First, the policy-maker knows that higher statutory CG standards introduced under macroeconomic volatility will induce the firms to avoid implementation. Therefore, and if the policy-maker is assumed to be a social-utility-maximising planner, s/he will refrain from introducing legislation that will remain largely ineffective. Second, and if the policy-maker is assumed to be an individual-utility-maximising opportunist, s/he will refrain from introducing new legislation because of lobbying activity and about threats of withdrawing contributions. Stated differently, the absence of a rule-based macroeconomic policy framework and the economic volatility it generates are likely to inhibit regulatory initiatives aimed at improving CG quality. In the context of Figures 1 and 2, this means that the neither public policy makers nor economic agents may be motivated to move beyond the sub-optimal, post-crisis equilibrium at A'.[2]

That could be the reason why both statutory and voluntary CG standards remained distinctively low in Turkey during the volatile period of the 1980s and 1990s. During that period, the Turkish CG regime was characterised by opacity and was prone to corrupt practices. The capital market was characterised by low liquidity, high volatility, high cost of capital (low firm valuation) and limited new capital formation. Controlling shareholders maintained large stakes and have leveraged cash flow rights due to privileged shares and pyramidal ownership structures. These deficiencies affected adversely not only the flows of foreign direct investments but also the development of an equity market into which both foreign and domestic savings could be channelled (Ararat and Ugur, 2002).

As the 1999 and 2001 crises in Turkey placed the cost of discretion and rent-seeking under the spot lights and the sustainability of the old policies became questionable, the economic policy framework has undergone significant change. The change involved a move away from discretion towards a rule-based policy framework. The transition was anchored by IMF conditionality and the prospect of EU membership. As a result, fiscal and monetary discipline has been restored. In addition, extensive public sector reforms reduced the scope for discretion and rent-seeking. For example, the Financial Management and Control Law (2002), combined with rationalisation of the government budget and investment, aimed at putting an end to moral hazard and perverse incentives generated by public policy. The Public Procurement Law (2001) and the Public Procurement Contract Law (2002), the Code of Ethical Conduct (2004) and Freedom of Information Act (2005) aim at addressing corruption. Finally, banking sector reforms aim to align the regulation and supervision standards with those of the European Union, and to restructure the state banks with a view for privatisation. These reforms can be expected to reduce the probability of policy-induced macroeconomic volatility. Even though IMF conditionality is coming to an end at the end of 2007, the start of accession negotiations with the EU is likely to provide a substitute anchor for the reforms carried out so far and a catalyst for further reforms.

The model proposed above enables us to analyse the likely effects of these changes on corporate governance quality in Turkey. Suppose that the equilibrium levels of CG quality and shareholder loyalty are determined at point A' in Figures 1 and 2. At this equilibrium, CG quality ($Q^{\wedge}$) and shareholder loyalty ($L^{\wedge}$) are lower than the benchmark levels determined at point A (Q^* and L^*). Given the transition to a rule-based macroeconomic policy and the increased probability of stability, we can expect the volatility of the stock market to fall. The fall in stock market volatility implies that shareholders are less likely to abandon the firm they invest in. This change on the part of the shareholders is induced by the fall in policy-induced risks that affect the firm's performance – and not by fall in market risks or management risks, which remain the same. Then, the increase in shareholder loyalty will lead to a rightward shift in the shareholders' reaction function (R'_s) to R_s. The shareholders'; new reaction function will intersect with the firm's existing reaction function (R'_f) at point C. At C, the level shareholder loyalty (not drawn) is higher than the level at point A'. This increase in shareholder loyalty will induce the firm to invest in higher CG standards – even if the statutory standards remain the same. We call this the "voluntary reform effect" on CG standards.

The return to a rule-based macroeconomic policy framework and the increased probability of economic stability also increases the feasibility of statutory CG reforms. This is for three reasons. First, the onset of the rule-based macroeconomic policy reduces the scope for

rent-seeking, which used to be justified by the argument that the government should compensate the firms for policy-induced risks. In other words, the resistance of the corporate sector against CG reforms can be expected to diminish. Second, the rule-based macroeconomic policy framework increases the credibility of microeconomic reforms, including CG reforms. Finally, the success of the rule-based macroeconomic policy depends on micro-level structural reforms. All these factors combine to induce policy-makers to introduce statutory CG reforms. Then the firm's reaction function will shift right from R'_f to R_f. The new reaction function will intersect with the shareholders' reaction function R's at point B in Figures 1 and 2. At B, the levels of CG quality (Q_b) are higher than the levels at A'. We call this the "statutory reform effect" on CG quality. If shareholders respond to this improvement by increasing their commitment to the firm, their reaction function (R'_s) will also shift to the right – leading to even higher levels of CG quality such as Q*.

In what follows, we will examine recent reforms to ascertain the extent to which the predictions indicated above have been supported by evidence on CG reforms in Turkey. Our examination begins with 2002, the first year after the end of the crisis-prone period. We focus on change in the following areas: (i) the effectiveness of regulatory authorities; (ii) disclosure and transparency rules; and (iii) the quality of the enforcement regime.

Macroeconomic stability and CG reforms after 2002

On 6 October 2004, in its recommendation that the European Union can start accession discussions with Turkey, the European Commission reported that "Economic stability and predictability have been substantially improved since the 2001 economic crisis. Persistently high levels of inflation have come down to historic lows, political interference has been reduced and the institutional and regulatory framework has been brought closer to international standards. Thus, an important change towards a stable and rule-based economy has taken place".[3] As Turkey embarked on the path towards the stabilisation reported by the EU Commission, we observed that the grim picture we drew about corporate governance quality (Ararat-Ugur 2002) also started to change rapidly.[4] First, the legal and regulatory framework for corporate governance was strengthened considerably. Second, enforcement has improved, alongside with accounting, reporting and audit standards.

Meanwhile, increased interest from foreign portfolio investors and direct investors in Turkish companies has forced insiders to put their house in order, to refocus on company's core activities and to move from a culture of risk aversion towards growth and risk management. In 2004 and 2005, M&A activities have increased to unprecedented levels[5] and equity finance gradually emerged as a viable financing option.[6] The trend in equity finance can be observed in Table 2, which reflects an evident increase in market capitalisation, average trading volumes, average floats and percentage of foreign holdings after 2001.

As equity finance has started to become a significant source of external finance for major Turkish companies, we observe two tendencies with respect to the quality of the corporate governance regime in Turkey. On the one hand, the Turkish government and regulatory authorities began to introduce new rules and regulations and amendments to the existing legislation. On the other hand, the corporate sector has started to reflect a higher degree of interest in the corporate governance (CG) debate and some even have begun to investigate the issue more systematically than ever before. Although international CG scandals and the international institutional reactions to these developments do have an effect on the change of attitude in Turkey, we believe that

Table 2: ISE in perspective

	1995 (US$)	2001(US$)	2005(US$)
Total market capital	20.8 billion	47.7 billion	132.9 billion*
Avg. daily volume	209 million	324 million	751 million
No. of listed companies	205	310	302
Average float (%)	20	24	31
Foreign holding (% of float)	46	50	66

Note: *As of 30 December 2005, total market capital reached US$162 billion.
Source: Ak Securities, as of November 2005.

the developments examined above would not have been possible had Turkey been still caught in recurrent boom–bust cycles. In the paragraphs below, we examine the nature of these developments and highlight the relationship between the latter and the return to macroeconomic stability in Turkey.

Effectiveness of regulatory authorities

Improvements in the regulatory framework were underpinned by the establishment of new regulatory institutions and strengthened the authority of existing ones. The Capital Markets Board of Turkey (CMB) who has the authority to regulate capital markets and oversee the functioning of Istanbul Stock Exchange (ISE), and the newly established Banking Regulation and Supervisory Agency (BRSA) were the main players in regulating and supervising the governance regime in Turkey.

The most significant step taken by the CMB in improving the regulatory framework is the issuance of a corporate governance code in July 2003 on a "comply or explain" basis. Before then, Turkey was the last OECD country which did not have a corporate governance code. The code is developed through an iterative process during which the CMB frequently consulted the market participants. "Corporate Governance Principles" are presented as the road map for future regulations by the CMB. In the preface of the Principles, it is clearly articulated that the voluntary nature of the Principles should not be taken lightly and "the explanation concerning the implementation status of these Principles, and the required explanation if not implemented, conflicts arising from incomplete implementation of these Principles, and explanation on whether there is a plan for change in the company's governance practices in the future should all be included in the annual report and disclosed to public."[7]

The Principles consist of four parts; part one includes the principles on shareholders' rights and their equal treatment. Issues such as shareholders' right to obtain and evaluate information, right to participate in the general shareholder meetings and right to vote, the right to obtain dividend, and provisions to protect minority shareholders rights are included in detail. Matters such as keeping the registry of shareholders properly and free transfer and sale of shares as well as equal treatment of shareholders are also covered. In part two, principles for disclosure and transparency are covered in detail. Part three is mainly concerned with stakeholders, a new concept for Turkish capital markets, which are defined as the company's shareholders and its workers, creditors, customers, suppliers, civil society, the government and potential investors who may decide to make investments in the company. Part four is focused on the board and includes issues such as the functions, duties and obligations, operations and structure of the directors, board committees and principles that bind the executives. The CMB repeatedly mentioned their intention to gradually move the recommended provisions into regulations as they are adopted by companies.

Initially, companies listed on the ISE took the new directives lightly. The annual reports for the year 2003 had few references to the Principles. However, the CMB's determination to implement the Code was demonstrated by formal inquiries, stricter review of prospectuses for new Initial Public Offerings (IPO), and by a communiqué clarifying the obligation to report on company compliance with the Corporate Governance Principles. In 2004 annual reports, all companies listed in ISE included a report on their compliance with CMB's CG Guidelines. Important matters such as financial reporting and audit standards are addressed by separate regulations. International Financial Reporting Standards are adopted; audit standards and processes are improved by the introduction of the mandatory rotation of external auditors, the formation of Audit Committees and individual sign-off of financial reports by the executives. In their report on the CG regime in Turkey, the International Institute of Finance declared that the Capital Markets Law (CML) and the CG Principles together meet all the requirements of international institutional investors (IIF, 2005). Table 3 provides a summary of regulation activity before and after 2001, reflecting the intensity of regulatory improvements after 2001. Given that 41 regulatory improvements out of a total of 45 were introduced in 2003 or thereafter, it is obvious that regulatory reform for improving CG standards has followed the return to a rule-based macroeconomic policy and the macroeconomic stability that this return has brought about.

While the general regime of corporate governance is improved, the banking sector, which was subject to separate legislation, went through a major restructuring process. Eighteen public and private sector banks have been taken over by the BRSA, at a total cost of US$47.2 billion – after it was established that these banks were unviable either because of non-functioning credits or outright tunnelling. A new Banking Act, prepared by BRSA, was enacted by the Parliament in 2005, setting the grounds for dissolving the financial and industrial arms of family-owned conglomerates by ensuring the reduction of connected

Table 3: Summary of corporate governance related regulatory activity before and after 2001 against the requirements of international standards

Topic	Standards required by the International Institute of Finance (IIF).	MANDATORY provision in Turkish Commercial Code (CC), Capital Market Law (CML), and Capital Market Communiqués (CMC) supporting the requirement *COMPLY OR EXPLAIN provisions supporting the requirement in Capital Markets Board's Corporate Governance Principles (CMB Principles)*
I. Minority Shareholder Protection		
I.A. Voting rights		
Proxy voting	Firms are encouraged to allow proxy voting.	(CC Art. 360 CMC Ser. IV, No. 8, Art 4 et seq.) – 1957, 2003 *(CMB Principles Sec. I Art. 4.6) – 2003*
One share one vote principle	"One share one vote" should be a threshold requirement for new issues.	No provisions *(CMB Principles Sec. I Art. 4.5) – 2003*
Cumulative voting	Cumulative voting should be permitted.	Optional *(CMB Principles Sec. I Art. 5, Sec. IV Art. 3.4) – 2003*
I.B. Capital structure		
Procedures on major corporate changes	Shareholder approval of mergers and major asset transactions should be required. If an offer is made above a reasonable minimum threshold of outstanding stock, a significant portion of that purchase must be through a public offer. Ownership exceeding 35% triggers a public offer in which all shareholders are treated equally. Under a merger or takeover, minority shareholders should have a legal right to sell shares at appraised value.	(CC Art. 388) – 1957 (CMC Ser. IV, No. 8, Art. 14 et seq.) – 2003 *(CMB Principles Sec. I Art. 3.6)* *(CMB Principles Sec. II Art. 1.11.5, 6) – 2003*
Capital increase (pre-emptive rights)	Shareholders approval is required. Any capital increase over a period of 1 year and above a minimum threshold must first be offered to all existing shareholders.	(CC Art. 388), (CML Art. 12), (CML Art. 12) – 1957 and 1992
Share buybacks	Details of share buybacks should be fully disclosed to shareholders.	Not permitted
I.C. Shareholder meeting		
Meeting notice and agenda	Meeting notice and agenda should be sent to shareholders within a reasonable amount of time prior to meetings.	(CC Art. 368) – 1957 *(CMB Principles Sec. I Art. 3) – 2003*
Special meetings	Minority shareholders should be able to call special meetings with some minimum threshold of the outstanding shares.	(CC Art. 366, CML Art. 11) – 1957 and 1992
Treatment of foreign shareholders	Foreign shareholders should be treated equally with domestic shareholders.	*(CMB Principles Sec. I Art. 8.1) – 2003* *FDI Law – 2004*

Table 3: Continued

Conflicts between shareholders	Should have mechanisms whereby a minority shareholder can trigger an arbitration procedure to resolve conflicts between minority and controlling shareholders.	(CC Arts. 348, 356, 367, 381 et seq., CML Art. 12) – 1957, 1992 *(CMB Principles Sec. I Art. 1, Sec. IV Art. 1.5) – 2003*
Quorum	Should not be set too high or too low. Suggested level would be about 30% and should include some independent non-majority-owning shareholders.	(CC Arts. 372, 388) – 1957
		CG-related regulatory activity subtotal before 2001 = 2 **CG-related regulatory activity subtotal after 2001 = 9**
II. Structure and Responsibilities of the Board of Directors		
II.A. Board structure		
Definition of independence	Cannot have a business or personal relationship with the management or company, and cannot be a controlling shareholder such that independence, or appearance of independence, is jeopardised.	No provision *(CMB Principles Sec. IV Art. 3.3.5) – 2003*
Share of independent directors	At least one-third of the board should be non-executive, a majority of who should be independent.	No provision *(CMB Principles Sec. IV Art. 3.2.1) – 2003*
Frequency and record of meetings	For large companies, board meetings every quarter, audit committee meetings every 6 months. Minutes of meetings should become part of public record.	No provision *(CMB Principles Sec. IV Arts. 2.16.2; 2.17.5; 2.19.1) – 2003*
Quorum	Should consist of executive, non-executive, and independent non-executive members.	(CC Art. 330) – 1957 *(CMB Principles Section IV Art. 2.18) – 2003*
Nomination of directors	Should be done by nomination committee chaired by an independent director. Minority shareholders should have mechanism for putting forward directors at Annual General Meeting (AGM) and Extraordinary General Meeting (EGM).	AGM or SGM (CC Art. 366) – 1957 *(CMB Principles Sec. IV Arts 5.2, 5.3. 5.7) – 2003*
Term limits for directors	For large companies, re-election should be every 3 years with specified term limits.	(CC Arts. 312, 314) – 1957 *(CMB Principles Sec. IV Art. 3.3.4) – 2003*
Board committees	The Board should set up three essential committees: nomination, compensation and audit.	(CMC Ser. X, No. 16 Art. 28/A) – 2003 *(CMB Principles Sec. IV Arts. 5.2, 5.3, 5.6, 5.7) – 2003*
II.B. Disclosure		
Disclosure of information that affects share prices	Any material information that could affect share prices should be disclosed through stock exchange. Material information includes acquisition/disposal of assets, board changes, related party deals, ownership changes, directors' shareholdings, etc.	(CMC Ser. VIII, No. 39) – 2003 *(CMB Principles Sec. II Arts. 1.3; 1.12) – 2003*

Table 3: Continued

Procedures for information release	Through local exchanges and as best practice, through company website.	(CMC Ser. VIII, No. 39, Art. 16) – 2003 *(CMB Principles Sec. II Art. 1.11) – 2003*
Remuneration of directors	Should be disclosed in annual report. All major compensation schemes, including stock options, should be fully disclosed and subject to shareholder approval.	(CC Arts. 333, 369) – 1957 *(CMB Principles II Art. 3.2.2) – 2003*
II.C. Other responsibilities		
Conflict of interest	Any potential or actual conflicts of interest on the part of directors should be disclosed. Board members should abstain from voting if they have a conflict of interest pertaining to that matter.	(CC Arts. 332, 334, 335) – 1957 *(CMB Principles Sec. IV Art. 2.20) – 2003*
Internal control and risk management system	Should be a function of the audit committee.	(CMC Ser. X No. 16 Art. 28/A) – 2003 *(CMB Principles Sec. IV Art. 1.3.2; 5.6.4) – 2003*
Investor relations	Should have an investor relations programme.	No provision *(CMB Principles Sec. I Art. 1.1) – 2003*
Social responsibility and ethics	Make a statement of policy concerning environmental issues and social responsibility.	No provision *(CMB Principles Sec. III Art. 6; 7) – 2003*
		CG-related regulatory activity subtotal before 2001 = 0 **CG-related regulatory activity subtotal after 2001 = 18**
III. Accounting/Auditing Standards		
National/international GAAP	Identify accounting standard used. Comply with local practices and use consolidated accounting (annually) for all subsidiaries in which sizable ownership exists.	(CMC Ser. XI No. 20 Art. 9; Ser. XI No. 25 Arts. 378 et seq.) – 2004
Frequency	Semi-annually audited report at end-FY.	(CMC Ser. XI No. 1 Arts. 48, 49; Ser. XI No. 3 Art. 10) – 2003
Audit quality	Independent public accountant. As a best practice, auditors should adhere to the global standards devised by the International Forum on Accountancy Development (IFAD).	(CML Art. 16/4) (CMC Ser. X No. 16 Arts. 32, 45) – 2003 (CMC Ser. X No. 16 Art. 24) – 2003 *(CMB Principles Sec. II Art. 4.1–2) – 2003*
Audit committee	For large firms, must be chaired by qualified independent director with a financial background.	(CMC Ser. X No. 16 Art. 28/A) – 2003 *(CMB Principles Sec. IV Arts. 3.1.5, 5.2, 5.3) – 2003*
Relationship/ communication with internal and external auditors	Committee should approve services provided by external auditor. Breakdown of proportion of fees paid for each service should be made available in annual report. Communication with auditors should be without executives present. Contemporaneous provision of audit and non-audit services from the same entity should be prohibited.	(CMC Ser. X No. 16 Art. 28/A) – 2003 *(CMB Principles Sec. II Art. 4.3.1; Sec. IV Arts. 5.6.1; 5.6.3; 5.6.4; 5.6.5) – 2003*

Table 3: Continued

		CG-related regulatory activity subtotal before 2001 = 0 **CG-related regulatory activity subtotal after 2001 = 9**
IV. Transparency of Ownership and Control		
Buyout offer to minority shareholders	Ownership exceeding 35% triggers a buyout offer in which all shareholders are treated equally.	CMB Principles on major corporate changes – 2003
Related-party ownership	Companies should disclose directors' and senior executives' shareholdings. All insider dealings by directors and senior executives should be disclosed.	(CMC Ser. VIII, No. 39) – 2003 (CML Art. 47) – 1992 (CML Arts. 15/7, 46, 47/A) – 1992 *(CMB Principles Sec. II Art. 2.3) – 2003* *(CMB Principles Sec. II Art. 5.2) – 2003*
Minimally significant shareholders	Shareholders with minimally significant ownership (greater than 3–10%) of outstanding shares must disclose their holdings.	(CMC Ser. VIII, No. 39, Art. 5) – 2003
		CG-related regulatory activity subtotal before 2001 = 2 **CG-related regulatory activity subtotal after 2001 = 5**
	Total CG-related regulatory activity before 2001 = 4 **Total CG-related regulatory activity after 2001 = 41**	

Source: Compiled from IIF report on Turkey (2005) and CMB website.

lending and limiting shareholding of banks in non-financial institutions by a maximum 15 percent of its own funds.[8] The Act gives ample powers to BRSA and holds the board and senior managers liable, jointly and severally, for the repayment of credits extended in violation of the Act. In addition to general technical requirements for prudent banking in the areas of accounting, risk management, internal control, bad loan provisions, capital adequacy, elimination of full state guarantee on deposits etc. towards the alignment with international best practices, the Act sets strict criteria on personal integrity for general managers, assistant general manages and board members of banks and authorises BRSA to issue mandatory Corporate Governance Rules which includes a strong component of independence in the Board assured by statutory approval of independent member nominations.

On-going privatisation of state shares in listed companies further supported the efforts to mitigate corrupt practices. Improvements in reduction in unregistered economy and tax collection is reinforced by a reduction in corporate tax rate from 30 to 20 percent, starting from 2006, indicating the government's confidence in their capacity and capability to increase tax collection as well as in the willingness of the companies to clean up their houses.

The regulatory improvements in the CG framework are underpinned by an ongoing fundamental revision of the legislative framework which is considered to be a major obstacle for real reform. Company Law, dated 1957 and borrowed from French, German and Swiss commercial codes, has not been revised since it was enacted, with a few minor exceptions, while French, German and Swiss commercial codes have gone through major revisions during the past 50 years. The inconsistencies between the Company Law's provisions and capital markets law and regulations, combined with inefficiencies in the judicial process, reduced the effectiveness of the regulatory reforms pioneered by the CMB (Ararat and Ugur, 2002). A long overdue major rewrite of the Company Law (1957) has been undertaken by a 45-member committee in the beginning of 2002, based on a government decision in 1999, and the resulting draft law which consists of more than 1500 articles was submitted to Parliament in November 2005. The draft reflects the strong political will to modernise company law with a commitment to market economy, free competition and generally accepted principles of good governance. A completely rewritten section on joint stock (anonym) companies tries to accord with the CML and CMB's CG Guidelines, especially in the area of accounting and reporting. A list of major provisions of the draft Company Law related to the governance of joint stock companies is presented in Table 4A.

Table 4A: Major provisions of the Draft Turkish Company Law (submitted to the Parliament in November 2005)

Articles related to corporate governance

Article	Provision	Authors' comments
1507	Authorises CMB to regulate and oversee CG rating.	
375.1/f	Preparing company's CG Statement and getting approval in the AGM is a reserved power of the Board.	
378	Mandates a Risk Detection Committee for listed companies and also for closed companies if the auditor recommends it to the board.	
398.2, 4	Mandates the auditor to report on whether the company has an effective system to identify and manage risks.	
367 and 369	Provides for the Board to delegate management to some of its members or third parties based on a comprehensive charter disclosed to the shareholders. Those who have been delegated have duty of care and loyalty (except the provisions of 203 and 205).	Article 203 accepts that the parent boards may give instructions to subsidiary boards which can be against the interests of the subsidiary. Article 203 removes all liabilities of the subsidiary board towards shareholders or debtors resulting from executing such orders (must be viewed with Article 202 which limits the nature of such instructions).
370	Board can delegate its representation to one or more of its members.	
397	Both the financial statements and annual reports are audited by external auditors.	
348	Founders can not have any privileged shares which may affect the share capital.	The same article provides for the founders' rights to receive a percentage (defined in AoA) of distributable profits to the founders even if the company does not distribute any dividends.
349	Introduces the "Statement of incorporation" explaining the status of the company, relations between shareholders, commitments to shareholders or third parties in a true and fair manner. It is submitted to the auditor and kept in the company registry.	This is an important inclusion in the sense that AoA does not have the same power as a "statement". All contributions (cash or in kind), beginning assets and liabilities are disclosed and the statement is signed by all founders.
351	Introduces "Incorporation Auditor's Report".	AoA, Founders' Statement of Incorporation and Incorporation Auditors Report are the main documents reflecting the beginning position of the company.
357	Mandates equal treatment of shareholders within the same class.	
358	Prohibits shareholders to borrow from the company.	Except capital commitments.
359	Abolishes the requirement for board members to hold shares in the company.	This is a positive move allowing professionalisation of board members. Note that the same article requires that at least 50% of the members and all members nominated to represent institutional shareholders must have higher education.
360	Provided that it is included in the AoA, a certain class of shares, or minorities as a class, can have the right to nominate board members.	AGM can not vote against the nominations and nomination right is not considered as a privilege.

Table 4A: Continued

Articles related to corporate governance

Article	Provision	Authors' comments
361	If Directors and Officers Liability Insurance exceeds 25% of the capital, it has to be disclosed and taken into consideration in CG rating.	
376–377	Obliges the board to call AGM once the company becomes illiquid, gives the right to propose an improvement plan to postpone payment of loans.	
408	Introduces and defines the Reserved Powers (and duties and responsibilities) of the AGM.	Election and dismissal of the board members and auditors, deciding on dividend pay, board compensation, financial reports, changes in AoA and decision to liquidate.
419	Mandates that every company has an AGM charter, main principles of which will be announced by the Ministry of Trade and Industry.	
428	Introduction of Institutional Representative as an authorised representative of minority shareholders. Candidates do not have to be shareholders; they register their interest 40 days before the AGM and issue a proxy statement about how they will vote in AGM. Supported by electronic voting.	In our opinion this is an original and creative approach to facilitate shareholder activism. Company also propose a person as institutional representative, but s/he has to be independent or two representatives are proposed, one has to be independent.
479	Limits the use of voting privileges in certain cases and limitation on the ratio of voting rights to cash flow rights is set by 15.	Changes in AoA, election of special auditors and decisions on prosecution for liability and dismissal.
1502	Obliges every company to have a website, allocate a special section of the website to "targeted content" which must include all public disclosure and shareholder communications. The content also includes but not limited to calls, financial reports, CG Principles compliance reports etc. All content should be kept for 3 years.	In our opinion this is one of the most important provisions in the draft. Targeted content can not be changed. Any omission from the "content" will create liability for the board.
1505	Electronic Voting becomes mandatory for listed companies.	In our opinion this article together with article 1502 and 428 represent radical improvements in promoting shareholder activism.
364, 463, 438–40, 412, 531, 389	Minority Rights are increased, including the right to apply to the courts directly.	Right to submit resolutions at the AGM for certain cases, right to apply to the courts to appoint a special auditor, right to apply to the courts to hold AGM, right to request change of auditor.
375	Introduces the concept of Reserved Powers (and duties that can't be delegated).	In our opinion this is an important development to empower the boards. Duties include directing the management, disclosure of CG statement, deciding on the principles of financial accounting and reporting, appointment and dismissal of executives and organising the AGMs.

Source: Own compilation from the Draft Company Law.

The draft aims to achieve a balance between promoting *efficient* enterprise (performance) and *effective* monitoring and control. Detailed references to manifestation of unfair competition, introduction of stock options, removal of the requirement for board members to hold shares in the company, statement of reserved powers of the board, introduction of vested shares and provisions for squeeze out and right to exit would have a performance effect. On the other hand, the draft sets high standards of control. Introduction of criminal liabilities for misconduct and the obligation for financial institutions to receive authorisation to vote on behalf of stock lenders and beneficiaries are examples. The draft mandates the companies to include electronic voting in their by-laws with a special wording that would be defined by law and cannot be altered by companies, an obligation which is supported by mandatory targeted websites to communicate with shareholders. Provisions on the exercise of shareholders rights are further supported by a high degree of reporting and audit requirements. Table 4B lists the extended rights of minority shareholders.

The preamble of the draft refers to shareholder democracy and mass ownership as desired outcomes of the law. The draft also introduces special mechanisms for pooling of minority votes for general assemblies. In our view, this radical redefinition of the legal framework with a strong emphasis on shareholders rights (and special references to group structures) reflects the confidence of the government in her moral authority and the belief that the corporate sector will comply given the prospects of growth. Table 4C summarises the provisions related with the group structures (based on Forum Europaeum Konnzerntrecht).[9]

A substantial revision of CML has also been initiated and the draft law is opened to public consultation on CMB's website. The draft includes major improvements in the authority of the CMB in exercising its powers and increases sanctions for misconduct both for the company as a legal person and additionally for the individuals involved in insider trading and manipulation. It authorises CMB to request disqualification of directors from the courts. The draft establishes professional organisations with statutory rights such as Independent Auditors Association, Asset Valuation Experts Association and Corporate Governance Association. It also provides for the establishment Capital Markets Institute as a research, training and certification institution and introduces a whole new set of financial instruments to meet the demand in the increasingly vibrant Turkish capital markets.

Another important area of reform was the foreign direct investment environment. To this end, the Direct Foreign Investment Law was enacted in June 2003. Improvements in the new Law, such as elimination of the requirement to obtain permission for FDI and reduction in red tape, are expected to have a

Table 4B: Articles related to minority shareholders rights in the Draft Turkish Company Law

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

Source: Own compilation from the Draft Company Law.

Table 4C: Provisions related to group companies and pyramidal structures in the Draft Turkish Company law

Articles related to parent–subsidiary relations (Articles 195–216)*		
195	Provides description of controlling shareholder, parent and subsidiary, group of companies. "Operations", whether they are in the form of a company or otherwise (one owner), and overseas operations are included in the definition.	In our opinion this is one of the most important introductions in the Draft. It assumes that "control" implies and includes "management". The opposite can not be defended. Control can be exercised through direct or indirect cascaded or pyramidal ownership structures and privileged shares. The definition includes off balance sheet operations in the group structure. The law recognises the responsibility of power and the trust of the consumers and society created by the reputation of the group.
199	Obliges both the parent and the subsidiary to report on the relations, defines "Dependence Report" as a statutory report.	Forces the related party transactions and pyramidal control relations to be disclosed.
201	Limits the voting rights of the subsidiary in the parent with 25%.	
202–203	Abuse of control rights by the parent is prevented by law (asset transfer, transfer pricing, preventing investments and growth, sacrificing the continuity of the subsidiary for the benefit of the company). This abuse can be based on an instruction or influence.	In our opinion this is one of the most important provisions in the Draft. The Article provides for the right of the shareholders of the subsidiary to seek remedy for harms caused by the parent for AGM decisions that they have voted against.
203, 204, 205	Parent board can give instructions and the subsidiary board can refuse to implement them if they lead to bankruptcy or illiquidity.	Board members of the subsidiary can not be held liable for the decisions made on instruction from the parent. However, such instructions can only be based on predefined concrete policies.
208	Right to buy the minority shares.	Parent can squeeze out the minority if it has more than 95% of the shares.
206	Parent company has to balance the losses of the subsidiary.	This article suggests that subsidiary boards can sign contracts to transfer financial liabilities to the parent.

Note: *These provisions are based on the Forum Europeaum's ZGR (1988) and EBOR (2000).
Source: Own compilation from the Draft Company Law.

mitigating effect on corruption and bribery as well as having a positive effect on FDI flows. The Bankruptcy Act (2003) is another addition to the improvements of the legal framework.

In terms of timing, it is clear that these regulatory reforms have followed the return to macroeconomic stability. That this sequence was not accidental can be seen in a number of statements or observations made by corporate actors, market operators and international agencies. For example, Bülent Eczacibasi, the former president of the Turkish Businessmen

and Industrialists Association (TUSIAD), associated the low CG standards of the pre-2002 period with the macroeconomic and political environment of the time. Speaking at a conference organised by TUSIAD in March 2002, he argued that the moral void that coloured public governance and the reluctance of external investors to enter the Turkish market were two significant obstacles to change in the governance of Turkish corporations. Without political will and a long-term perspective in public governance, Eczacibasi argued, it would be almost impossible to engage in banking sector reforms and capital market regulations – both of which are essential for increasing the supply and ensuring the efficient allocation of financial capital.

The government's stability-oriented monetary and fiscal policies, combined with a much-needed shakeout of the banking sector is "working wonders on investor confidence levels, leading to more and more financing opportunities"[10] according to market professionals. Investment analysts interviewed in 2005 by the financial press confirm an increased interest in Turkish equities and corporate bonds following the reforms: "...legislation is the indispensable vehicle, but the economy is the driver. Stability not only reassures the rating agencies, it is nurturing the underlying markets that will feed the new deals. Continued growth will allow the banks to push forward mortgages, credit cards and loans."[11] As predicted by our model, sustained high growth for the past three years and prospects of sustained stability changed the demand and supply functions of finance and corporate governance as a risk factor.

The growing interest in Turkish equities also encouraged Turkish firms to pursue international expansions and greenfield investments. For example, Efes Beverage Group, which commands 80 percent of the domestic market for beer, is expanding in international markets, a strategy which led Efes to list 30 percent of its Dutch-based global beer subsidiary on the London Stock Exchange (LSE). "Because of the instability in the past", explained the CFO of Efes, "we were used to always being on the defensive – always trying to be very liquid and rely on our own equity".

The demand for Turkish equity strengthened, alongside the international banks' appetite to extend credits to Turkish banks and top tier companies as Turkey became more stable. Indeed, the accelerated sale of a 2 percent stake in Turkcell – the only Turkish company listed in NYSE – in 2005 was very successful; 24.36 million shares were sold in 90 minutes demonstrating that investors were following the Turkish market closely. "No investor can ignore Turkey any more", reported *Euroweek*, based on interviews held with investment professionals.[12] On the other hand, despite the abundance of opportunities at the moment, "Turkish companies and their owners do not want to sell out soon", says a Deutsche Bank officer, as "the valuations are likely to continue to increase further given the record levels of FDI and portfolio investments".[13] The Grant Thornton survey supports this view as Turkey is ranked at the bottom of 24 countries with respect to expectations of the business owners in the change of ownership. The business owners' survey conducted by Grant Thornton,[14] which covers 6000 mid-sized companies in 24 countries, puts the Turkey in top-five countries with the highest expectations for increased capital investments, export and employment. Turkey also ranks the first in expectations of profitability. According to the same survey Turkish mid-sized companies' expectation on their own country's economic performance is 49 percent better than the average of 24 countries surveyed, demonstrating the perceived link between macroeconomic performance and firm performance.

Changes in disclosure and transparency rules

Governance mechanisms such as markets for corporate control and executive compensation schemes, which are effective in developed markets, are less effective as governance mechanisms in the presence of large controlling shareholders. Disclosure is the fundamental form of minority protection that increases the cost of expropriation for the controlling shareholders. While other aspects of corporate governance are highly debated, reflecting different views of what constitutes good corporate governance in the context of concentrated ownership, there is a broad consensus about the importance of disclosure. Full disclosure and transparency of financial information, in addition to disclosure of governance arrangements, is a vital component of the CG framework and regarded as an important indicator of CG quality.[15] Indeed, Beeks and Brown (2005) find that firms with higher CG quality make more informative disclosures. To the extent the benefits of disclosure exceed its costs to the company and the owners, we expect the firm to cooperate with the rule-maker and increase its disclosure and transparency. Otherwise, powerful owners tend to influence the legislative and regulatory process and they may block implementation of reforms (Berglof and Pajutse, 2005).

Macroeconomic stability can be considered as a factor that increases the benefits associ-

ated with each level of disclosure cost. This is because macroeconomic stability induces portfolio capital inflows and reduces the probability of one-way outflows that cannot be explained by company performance only. Therefore, we expect macroeconomic stability to make statutory and voluntary disclosure more incentive-compatible compared to the period of macroeconomic instability. Indeed, we observe that the onset of macroeconomic stability in Turkey has been associated with improvements in the statutory disclosure regime and in the level of voluntary disclosure standards.

The disclosure infrastructure for listed firms has been strengthened in the last few years through new decrees issued by the CMB on auditing and accounting standards and as a result of improvements in the technological infrastructure. In 2003 the IFRS became an optional standard accepted by the CMB and finally it has become the mandatory standard as of 2005, putting Turkey ahead of many EU countries in adopting international accounting standards. New regulations have also been adopted in harmony with international audit standards. Listed companies have to establish "Audit Committees" headed by a non-executive director and officers have to personally sign-off the financial reports with the statement that the information reflects the financial position and operating results of the company and that the reports do not include unfair, misleading or deficient explanation; a practice largely refused by some EU states, although it is incorporated in Corporate Governance Action Plan and Financial Services Action Plan.[16] External audit standards have been substantially improved in the process by strengthening the regulatory oversight of audit companies, requesting rotation of auditors every 5 years and mandating the separation of consulting and auditing activities. Audit companies are approved by the CMB and they are subject to civil actions if their letter misleads the investors. A 286 page communiqué on implementations of regulations on independent audit standards is in the process of public consultation.[17]

The Draft Company Law introduces a concept of "financial statement and annual report audit". Auditors are expected to audit both the financial statements and the annual report; auditing of the financial statements would be to ensure adherence to accounting and financial reporting standards as well as to the company's articles of association, auditing of annual report is expected to ensure the report represents a true and fair picture of the company's position to the shareholders. Obligation to have a website with a special section dedicated to statutory shareholder communication with historical data is another reflection of intentions to improve transparency. The provisions of the Draft related to transparency and disclosure are listed in Table 5. The proposed legislation encourages extensive use of electronic disclosure by the joint stock companies and mandates it for listed companies. The scope of disclosure is radically expanded with special provision for disclosure of related party transactions.

Voluntary disclosure has been gradually improving in parallel to statutory requirements. Aksu and Kosedag (2005) surveyed the companies that are constituencies of S&P/IFC Turkey Index[18] and found that 66 percent of the companies had opted for early adoption of IFRS as of 2003 voluntarily before it became mandatory in 2005. They also found that the early adopters of IFRS had higher overall T&D scores. A survey recently conducted by Sabanci University's Corporate Governance Forum and S&P evaluated disclosure practices of 52 companies listed on the ISE. The survey compared these companies with companies in other markets, which are surveyed by S&P with the same methodology. The results presented in Table 6 reveal that Turkey compares with Emerging Asia, is better than Latin America and slightly worse than Asia Pacific (S&P, 2005).

This evidence suggests that the transition to a rule-based economic policy and macroeconomic stability has been followed by radical improvements in Turkish CG standards concerning transparency and disclosure.

Corporate Governance Principles Compliance Report is a disclosure of corporate governance arragengements of listed companies against the CMB's Principles of Corporate Governance and was enforced in 2004 by the CMB. A review of compliance reports in 2004 indicates that the regulator's will to improve transparency of governance arrangements through compliance reporting did not meet resistance and indeed facilitated transparency as many companies voluntarily disclosed additional information that had not been disclosed elsewhere in their compliance reports. Although the contents are far from being satisfactory, the initial results of CGFT's comparative survey of Turkish companies' transparency and disclosure practices reveal significant improvements in voluntary disclosure triggered by compliance reporting.

A recent project called Public Disclosure Platform (KAP), which is undertaken by CMB, ISE and BILTEN (Turkish Information Technologies and Electronics Research Institute), aims to transform the Public Disclosure regime in Turkey. Public disclosure in Turkey

Table 5: Major provisions related to disclosure and transparency in the Draft Turkish Company Law

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

Source: Own compilation from the Draft Company Law.

Table 6: Comparison of transparency and disclosure scores (out of 100)

	Composite score	Ownership structure	Financial disclosure	Board structure and processes	Number of companies
UK	70	54	81	70	124
Europe	51	41	69	41	227
US	70	52	77	78	500
Japan	61	70	76	37	150
Asia-Pacific	48	41	60	42	99
Latin America	31	28	58	18	89
Emerging Asia	40	39	54	27	253
Turkey	41	39	64	20	52

Source: Own compilation from S&P 2005 and CGFT's data.

is currently facilitated by means of Prospectus and Circulars, Financial Statements and Reports and Public Disclosure of Material Events. Weekly bulletins of CMB report disclosure of material events that may affect company's market value, especially changes in ownership and management, fixed assets through sales or purchases, business activities, investments and the financial situation of the company. In the case of subsidiaries, changes in the parent company are also required to be disclosed. Irregularities and non-compliance can be subject to criminal law. The CMB's new Public Disclosure Platform (KAP),[19] which will employ digital certificates and electronic signatures, will enable all disclosure to be disseminated electronically via the Internet. The system has been in test run since November 2004 and it is expected to be live in full operation in 2006. According to CMB resources, all

listed companies will be mandated to use their websites to simultaneously publish all public disclosure reported through KAP.

A review of the Transparency & Disclosure Index study and the corporate governance compliance reports issued by the listed companies in their 2004 annual reports reveals that the companies who had major external financing deals (related with both sale of equity or borrowing) rank at the top of the index. This finding supports our argument that macroeconomic stability created an environment where the increase in the supply and demand for finance had become possible and thereby both statutory and voluntary corporate governance reforms became feasible (see S&P, 2005; Ararat and Ugur, 2005).

A statement by the Chief Financial Officer of Unilever reveals another aspect of the relationship captured in our model:

> *There is an entire generation of finance staffers in Turkey that has only ever known deep-rooted hyperinflation – and the short-term mindset it necessitates. The skills of accurate reporting, planning and forecasting were next to impossible to hone in that environment. . . . those years were characterised by a short-term mindset and blind decision-making.*[20]

Under these conditions, equity finance remained an unattractive option and so did the need for corporate governance reforms. However, as equity finance, especially international equity finance, became a viable option after the return to macroeconomic stability, the need for CG reforms became both evident and feasible. Interviews with 20 business owners confirmed that the major driving force for improving the accounting and reporting practices was the feasibility of external finance and the need to tap into this source. "What can you discuss with potential investors if you do not have an understandable financial statement that investors can compare and judge?" said one of the owners in a private interview.

Quality of enforcement regime

Corporate Governance mechanisms in developing countries primarily depend on large block holders, bank monitoring (depending on the health of the banking system), reputation and self enforcement rather than market control and law enforcement. Empirical evidence shows that it is not the presence of laws but rather enforcement that helps to explain the development of securities markets, as enforcement is key to effective corporate governance. For example, Bhattacharya and Daouk (2002) found that 70 percent of emerging markets have not enforced their insider trading laws.[21] In many developing countries where the general enforcement environment is weak and governance mechanisms function poorly, concentrated ownership becomes the predominant form of corporate governance. As discussed earlier, concentrated ownership (patronage) is a potent form of governance, but it is also associated with entrenchment of the owner, higher risk exposure and liquidity constraints. At the aggregate level, these lead to poor development of capital markets and the impediment of growth. In the end, effectiveness of all other mechanisms depends on the political will to enforce laws and regulations.

Our model incorporates the two problems of external finance in developing countries. The first is that the cost of collecting information and private enforcement is high for the investors and hence they choose to exit rather than monitor. The second issue is that even if the firm chooses to keep its commitment to CG quality, its commitment would not be credible as institutions are missing or not functioning. Therefore entrenchment becomes an alternative to performance-related benefits for the controlling owners in the absence of public enforcement and prospects of growth. In what follows, we explain the change in the quality of enforcement regime in Turkey with respect to corporate governance as the overall institutional quality is increased together with improvements in macroeconomic stability.

Throughout the 1990s, there were severe operational problems with the legal process and law enforcement in Turkey. First of all, ministers and members of parliament enjoyed extensive immunity against corrupt practices, which included permissive supervision, lenient law enforcement and distribution of rents in return for political support (see Ugur, 1999, pp. 68–75). Second, the process was complicated, slow and costly; or it was unpredictable due to heavy reliance on decrees. Third, the general inefficiency of the legal process and the weaknesses in law enforcement compromised the institutions that were introduced to supervise listed corporations. After 2001, a number of instruments were introduced to strengthen the enforcement such as the New Civil Code and Civil Procedure Code (2002), the New Panel Code and Panel Procedure Code (2002) to improve the judicial independence, and law on Justice Academy (2003) to improve court efficiency.

Since 2000, the CMB has filed complaints to the office of public prosecutors for around 100 violations of Capital Market Law (CML) every year. Only one case in each year has reached decree absolute, with the rest resulting in dis-

Table 7: Cases commenced after application of the CMB to the public prosecutor

Year	Number of applications	According to topics			Judging stage		
		Insider trading	Manipulation	Others	Investigation	Pending	Adjudicated*
2002	124	1	78	45	41	40	43
2003	158	1	93	64	67	84	7
2004	124	2	77	45	78	46	0
2005	34 (4 months)						

Note: *Out of 50 cases in 2002–2003, only one case resulted in condemnation (2%), 39 cases were suspended and four were dismissed.
Source: CMB Annual Report, page 75. 2005 data are calculated from the website.

Table 8: Administrative fines issued by the CMB

Period	Number of administrative fines
9.5.2000–31.12.2000	124 (372 extrapolated for 12 months)
2001	227
2002	282
2003	185
2004	188
2005	78

Source: Own source calculated from CMB website, http://www.spk.gov.tr, January 2006.

missals and adjournments. The average time between the CMB's appeal and the first verdict (excluding decisions on adjournment and dismissal) was more than 12 months. The public prosecutor had not reacted to files concerning 26 cases in 2001 and half of the cases in 2002. The result is that only 1 percent of all complaints ended up with any punishment (http://www.spk.gov.tr). However, in line with our argument that macroeconomic stability provided incentives for improvements in corporate governance for the firms, we observe improvement in compliance. While public prosecution remains to be ineffective as demonstrated in Table 7 and while there was a substantial increase in regulations and market activity, the number of violations taken to the public prosecutors by the CMB and the administrative fines issued by the CMB decreased considerably in 2004 and 2005 (Table 8).

In Turkey, violation of CML is not sufficient for prosecution, which takes place only after application by the CMB. Therefore, it is important that the regulator has the means and capacity for market surveillance. The CMB has invested considerably in renewing its information system and technical infrastructure in recent years. The new system, which provides for a real time monitoring of the market, has capabilities to give early warnings about abnormal security trades. It also incorporates Public Key Infrastructure technology, which allows the use of digital certificates and digital signatures for the timely electronic disclosure of financial and non-financial information via a secure computer network. The system, which further includes order matching, document management, capital adequacy monitoring of intermediaries and portfolio management companies, demonstrates the commitment of the regulator to enforcement.

The CMB took further measures to encourage investors to play a monitoring role by establishing a task force within CMB with the mandate to respond and act upon investors' requests for information. In 2003 and 2004, 5859 request for information were submitted to the CMB and 97.20 percent of these were concluded.[22]

During the crisis years, the role played by civil society against corruption and in

monitoring corporations was extremely limited. First of all, restrictions imposed upon civil society organizations, coupled with a highly monopolised media and the tradition of opacity, exacerbated the information asymmetry between society on the one hand and the state and the private sector on the other. Second, corruption was legitimised in the eyes of civil society due to the moral void (Ararat 2004). Turkey made significant progress during the last few years in establishing freedom of speech and organisation, a process influenced by EU accession. These developments are expected to improve the enforcement power of society over corporations. New Labor Law (2003), which improves employee rights, is also expected to have a positive effect on monitoring by employees.

Conclusion

The analysis above demonstrates that there has been an evident association between Turkish CG reforms and Turkey's return to macroeconomic stability since 2002. Of course, association does not necessarily imply causation that runs from macroeconomic stability to improved CG quality. In this paper, however, we argued that such causation did exist and that the return to macroeconomic stability has been a significant determinant of recent improvements in the Turkish CG regime. We identified two avenues through which macroeconomic stability has led to better CG quality.

On the one hand, macroeconomic stability has reduced the risks and increased the returns associated with investment in the Turkish stock market. As a result, new investors have entered the market and volatility that is not strictly related to company performance has diminished. This increased "loyalty" of the investors made the companies' investment in CG reforms incentive-compatible. Therefore, Turkish companies relying on or planning to draw upon equity finance have become more willing to invest in CG reforms. On the other hand, the return to macroeconomic stability weakened any resistance against CG reforms. This was the case because macroeconomic stability was underpinned by increased credibility of the public policy in general and the new CG legislation in particular. This credibility effect increased the probability of compliance and encouraged the policy makers to press ahead with further reforms.

The analysis above show that the regulators and the government moved forward with corporate sector reforms with confidence for two reasons: (i) they did not expect a serious reaction from the corporate sector because the cost of improved corporate governance is justified given the prospects of sustainable macroeconomic stability and economic growth and (ii) they had built the credibility to enforce regulations by improving public governance. These findings are in line with the predictions of the proposed model above and are parallel to Perotti and Volpin (2003), who find that higher political accountability (i.e. a rule-based policy environment) is associated with more effective legal enforcement, even after controlling for legal origin and per-capita income.

Of course, these findings do not exclude the possibility that other factors such as international CG scandals, the reactions of national and international agencies to such scandals, and the competition for attracting portfolio investment, etc. may also have had a positive effect on CG reforms in Turkey. Nevertheless, in the Turkish context, the evidence we examined suggests that international developments would have failed to trigger the extent of reforms examined had macroeconomic *instability* been still the norm. In other words, macroeconomic stability after 2002 acted as an intervening variable between the external pressure for change and the level of domestic CG reforms in Turkey. This observation leads to the argument that international pressure for CG reform is not likely to generate significant improvement in CG quality in emerging market economies unless the latter have a stable macroeconomic environment and commitment to a rule-based economic policy framework to underpin that environment.

Notes

1. On institutional quality, see Ugur (2004). On fiscal indiscipline, see World Bank (2001) and Sayistay (2000).
2. See Bhattacharya and Daouk (2002, 2005) for a discussion on why no-law may be better than a law that is not enforced and the effect of enforcement of law on the cost of equity.
3. See EU Commission (2004, p. 70).
4. For details about the evolution of CG regime see Ugur and Ararat (2005) and Ararat and Ugur (2005).
5. M&A activity has been less than US$500 until the last few years, but increased to US$10 billion in 2004 and an all-time high of US$31 billion in 2005.
6. IPO activity was resumed in 2004 with 12 IPOs after complete suspension, for yearly figures see ISE website http://www.ise.gov.tr (accessed January, 2006).
7. See http://www.spk.gov.tr (accessed January, 2006).
8. See http://www.bddk.gov.tr (accessed January, 2006).

9. "Corporate Group Law for Europe" is a joint effort of Forum Europeaum which consists of legal scholars with ties with practice. For details see Irujo (2005).
10. CFO Europe, October 2005, p. 21, http://www.cfoeurope.com (accessed January, 2006).
11. Euroweek, June 2005, p. 12, http://www.euroweek.com (accessed January, 2006).
12–13. Euroweek, June 2005, p. 17, http://www.euroweek.com (accessed January, 2006).
14. Grant Thornton International Business Owners Survey, http://www.grantthorntonibos.com (accessed January, 2006).
15. In their official report titled "Corporate Governance: the Turkish Transparency and Disclosure Survey", Standard & Poor's states that they view corporate transparency as an important factor affecting a company's attractiveness to investors, and as a vital element of corporate governance.
16. See http://europa.eu.int/comm/internal_market/company/modern (accessed January, 2006).
17. See CMB's website, http://www.spk.gov.tr (accessed January, 2006).
18. The constituencies are the largest and most liquid 51 companies in ISE, http://www.standardandpoors.com (accessed February, 2004).
19. See the test site: http://www.kap.spk.gov.tr (accessed January, 2006).
20. CFO Europe, October 2005, p. 18, http://www.cfoeurope.com (accessed December, 2005).
21. In case of Turkey the insider trading was prohibited by law in 1981, but the first enforcement was in 1996 Bhattacharya and Daouk (2002).
22. CMB Annual Report (2004), http://www.spk.gov.tr (accessed January, 2006).

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