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# Corporate Governance Practices in Turkey as a Candidate Country to the European Union: A Comparative Analysis between the European Union and Turkey

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Joint Master's Programme European Studies Master Thesis

Antalya / Hamburg, 2012

Akdeniz Üniversitesi
Sosyal Bilimler Enstitüsü Müdürlüğüne,

Kadir ÇAKAR'ın bu çalışması jürimiz tarafından Uluslararası İlişkiler Ana Bilim Dalı Avrupa Çalışmaları Ortak Yüksek Lisans Programı tezi olarak kabul edilmiştir.

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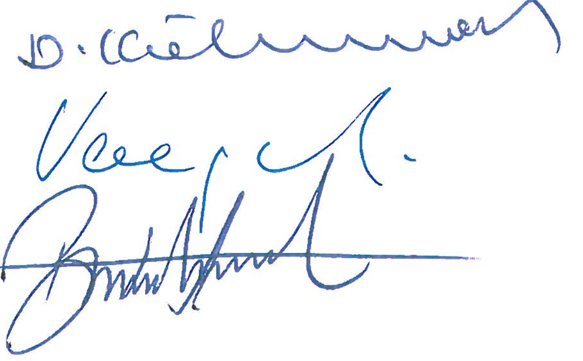

Tez Başlığı:

Corporate Governance Practices in Turkey as a Candidate Country to the European Union: A Comparative Analysis between the European Union and Turkey

Onay : Yukarıdaki imzaların, adı geçen öğretim üyelerine ait olduğunu onaylarım.

Tez Savunma Tarihi 09/01/2012
Mezuniyet Tarihi 02/02/2012

Prof. Dr. Mehmet ŞEN
Müdür

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**LIST OF ABBREVIATIONS**

| | |
|---|---|
| AGM | Annual General Meeting |
| BRSA | Banking Regulation and Supervision Agency |
| CACG | Commonwealth Association for Corporate Governance |
| CEO | Chief Executive Officer |
| CGAT | Corporate Governance Association of Turkey |
| CLAP | Company Law Action Plan |
| CGP | Corporate Governance Principles |
| CMB | Capital Markets Board of Turkey |
| CML | Capital Market Law |
| CSR | Corporate Social Responsibility |
| ECGF | European Corporate Governance Forum |
| ECGI | European Corporate Governance Institute |
| ECGN | European Corporate Governance Network |
| EC | European Commission |
| EU | European Union |
| FDI | Foreign Direct Investment |
| FRC | Financial Reporting Council |
| GCGF | Global Corporate Governance Forum |
| GDP | Gross Domestic Product |
| IRFAA in Eurasia | International Regional Federation of Accountants and Auditors |
| ICC | International Chamber of Commerce |
| ICGN | International Corporate Governance Network |
| IFRS | International Financing Reporting Standards |
| IMF | International Monetary Fund |
| IAS | International Standards on Accounting |
| ISE | Istanbul Stock Exchange |
| ISS Europe | Institutional Shareholder Service Europe |
| NASDAQ Quotation System | National Association of Securities Dealers Automated |
| MPS Index | Minority Shareholders Meeting Index |
| NGO | Non-Governmental Organisation |

| | |
|---|---|
| NYSE | New York Stock Exchange |
| OECD | Organisation for Economic Co-operation and Development |
| SEEPAD | South Eastern European Partnership on Accountancy Development |
| SOX | Sarbanes Oxley |
| SOEs | Stated-Owned Enterprises |
| UK | United Kingdom |
| USA | United States of America |
| TCC | Turkish Commercial Code |
| TUSIAD | Turkish Industrialists' and Businessmen's Association |
| TASB | Turkish Accounting Standards Board |

# ABSTRACT

It is notable that there is a strong link between good corporate governance and economic performance of the countries and firms in creating greater performance in the business sector. It is also clearly known as a set of rules and of which principles emphasize not only the relationship between shareholders and stakeholders but also the interests of various groups such as providers of credit, suppliers and customers to reach particular outcome at both country and firm level. In order to balance sustainable economic growth successful implementation of corporate governance is provided by the help of its basic principles that should be based on the principles of transparency, accountability, fairness and responsibility.

This study deals with the evolutionary path of the corporate governance in more details and also pays considerable attention to different corporate governance practices both in Turkey and the EU. It also reviews chronic corporate governance problems in Turkey from the point of view of the EU by considering a comparative perspective. In that sense, this study also addresses the strengthening and developing elements and theories of the corporate governance concept, which have affected the improvement of the corporate governance applications to reach high standards. Also the development of corporate governance practices will take place at the centre of this study with its strengths, weaknesses, similarities and differences in the light of Turkish membership for the EU.

It also pays particular attention to the relationship between ownership and control, its effective role and applications. In order to have better information about company's activities and strategies in time, for the benefits of the investors, importance of transparency and disclosure issues have been emphasized in this study. In this scope, the solutions will strongly be stressed which are needed to reach particular results. In addition to that the interactions between management and the supervisory board will be a focal point of the study as it is the case of benefits of the successful implementation of transparency and disclosure. In conclusion, this study highlights importance and the advantages of successful implementation of good corporate governance in the creation of wealth, more jobs and sustainability for companies and to provide sustainable economic growth for the governments.

**Key Words:** Corporate Governance, Turkey, European Union, Standards of Corporate Governance

# ÖZET

## AVRUPA BİRLİĞİ'NE ADAY OLAN TÜRKİYE'DE KURUMSAL YÖNETİM UYGULAMALARI: TÜRKİYE VE AVRUPA BİRLİĞİ ARASINDA KARŞILAŞTIRMALI BİR ANALİZ

Bilindiği gibi iyi bir kurumsal yönetim ile ülkeler ve firmalardaki güçlü ekonomik performansı yaratma arasında sıkı bir bağ bulunmaktadır. Genel olarak da kurumsal yönetim prensiplerinin istenen sonuçlara ulaşmada sadece hissedarlar ve paydaşlar arasındaki ilişkiyi belirleyen değil bunun yanı sıra kredi sağlayıcılar, tedarikçiler ve müşteriler gibi değişik çıkar grupları arasındaki ilişkileri de belirleyen bir kurallar bütünü olarak bilinir. Sürdürülebilir ekonomiyi dengede tutmak için iyi bir kurumsal yönetimin uygulanması temel kurumsal yönetim ilkesi olarak da bilinen şeffaflık, hesap verebilirlik, adillik ve sorumluluk sayesinde sağlanır.

Bu çalışma Kurumsal Yönetimin gelişim sürecini detaylarıyla ele almakta olup hem Türkiye'deki hem de Avrupa Birliğinin bazı ülkelerinde mevcut Kurumsal Yönetim uygulamalarını incelemektedir. Ayrıca bu çalışmada Türkiye'deki Kurumsal Yönetimin kronik sorunları Avrupa Birliği süreci göz önüne alınarak karşılaştırmalı bir bakış açısıyla değerlendirilmektedir. Bunun beraberinde daha verimli sonuç elde etmeye yönelik olarak Kurumsal Yönetim kavramını güçlendiren ve geliştiren unsurların neler olduğu da vurgulanmaktadır. Kurumsal yönetim uygulamaları güçlü ve zayıf yönleriyle birlikte benzerlik ve farklılık gösteren noktalarıyla da bu çalışmada Türkiye'nin Avrupa Birliği'ne üyelik süreci ışığında esas olarak ele alınmaktadır.

Mülkiyet, kontrol etkinliği ve uygulamadaki etkin rolü de bu çalışmada ayrıca bütün yönleriyle incelenmektedir. Bunlara ek olarak şirket faaliyetleri ve stratejileri hakkında daha iyi bilgiye zamanında ulaşmak için yatırımcıların yararını gözeten şeffaflık ve bilgilendirmenin önemi vurgulanmaktadır. Şeffaflık ve bilgilendirmedeki başarılı uygulamalarda olduğu gibi yönetim ve teftiş kurullarının işlevi ve önemi yine bu kapsamlı çalışmada vurgulanmaktadır. Avrupa Birliği standartlarıyla yapılan karşılaştırmalı bir analizden sonra Türkiye'deki kurumsal yönetim uygulamalarıyla ilgili düzenlemelerin bu standartlara ulaşmadaki boyutuna da ışık tutmaktadır. Sonuç olarak bu çalışma şirketlerin sürdürülebilirlikleri adına daha fazla sermaye ve iş olanağı yaratma ve yine ekonomik kalkınmayı sürdürülebilir kılmada başarılı Kurumsal Yönetim uygulamalarının avantajlarına değinmektedir.


**Anahtar Kelimeler:** Kurumsal Yönetim, Türkiye, Avrupa Birliği, Kurumsal Yönetim Standartları

# INTRODUCTION

It is obvious that the main purpose of good corporate governance is to response to the challenges that occurred after several corporate collapses which have had an adverse effect on shareholders, employees, companies, and governments to a considerable extent. It also directly affects financial investment of shareholders to a large extent, employees who have lost their jobs, and the economic impact on government as well as companies (Christine, 2010:1). Corporate governance is described as a set of rules in balancing relations between different interests groups like shareholders, creditors, employees, suppliers and customers that pertain to stakeholders. In order to provide sustainable economic growth, successful implementation of corporate governance is governed by the help of its basic principles that should be based on the principles of transparency, accountability, fairness and responsibility.

Also, it became major consideration in the public debate and business sector due to fact that it gave rise to remarkable results in emerging markets and governments' economies. Therefore, sound corporate governance occupied significant place in the agenda of various disciplines such as finance, economics, law, accounting, and management. Particularly, after Enron scandal in the United States of America (USA) and well-known Parmalat case in Central Europe which made essential to take measures in maintaining investor confidence. As a consequence, in order to create higher market value and increase investment performance more attention has been redirected to develop better corporate governance practices.

In parallel to these developments, Organisation for Economic Co-operation and Development (OECD) Council Meeting Ministerial focused on developing a set of corporate governance standards and guidelines to be applied in accordance with national governments, other relevant international organizations and the private sector (OECD, 2004:13). Since there are strong relation between economic growth and size of the country's capital market better corporate governance arises to serve this process with strong enforcement law and regulations. Considering role of the stakeholders in a good corporate governance system that they have significant roles to promote current corporate governance practices and play a crucial role within the process. Thus, the focal point of corporate governance is to assure stakeholders' confidence as well as to promote shareholders' rights.

Taking into consideration the Turkish corporate governance structure and management culture, the current corporate governance regulations and practices in Turkey will largely be

analysed in comparison with the current implementation in some selected EU countries within the context of the EU accession process of Turkey. Also, it will be compared with the current applications in Turkey that are predominantly based on Family owned companies which is seen as a problematic issue with respect to corporate governance practices, in particular, on separation of ownership and control issue. Since the Turkey is known a country as land of uncertainities due to instable atmosphere in macro-economic structure that derives from financial crisis and due to inadequate economic performance, deriving from political wilderness, inflationary chaos, vulnerability of Turkish economy and uncertainties, led to adverse effects on Foreign Direct Investments (FDI) entering to the Turkish markets.

In the light of above statements, in the study the development of corporate governance practices and models will take place at the centre of debate in the light of Turkish membership to the EU. Also, to make the ground of discussion clear and understandable on the basis of corporate governance practices, related regulations of Turkey will be examined compared to the EU current best practices of corporate governance. In addition, it will also be measured with its strengths, weaknesses, similarities and differences that to what extent Turkey's corporate governance regulations need to improve in comparison with the EU corporate governance requirements and regulations including recent developments. *Here arise the questions of how do the standards of corporate governance of Turkey compared to the theoretically drive standards of good corporate governance and does full membership of Turkey to the EU remedy and overcome current corporate governance chronic problems of Turkey such as weak law, regulations and shareholder rights*.

The aims of this study highly depend on two main domains both in the EU and Turkey. Before all else, the objectives of the study originate from five main steps that are mentioned in the following statements:

1. To establish evolutionary process of the corporate governance practices and regulations by considering its dimensions and chronicle problems in Turkey. Hereby, to outline an overview strengths, weaknesses, similarities and differences between the EU and Turkey by highlighting distinctive features and economic indicators in the light of corporate governance practices that they currently have.
2. Taking into consideration the Turkish accession process to the EU, testing and analysing national current procedures and regulations by considering international standards that are used to enhance corporate governance norms.

3. To emphasize the benefits of corporate governance practices and address EU Directives and Regulations for moving country forward in accordance with the *acquis communitaire* within the EU accession process of Turkey and to build understanding and awareness of the EU corporate governance directives, regulations, best practices, and guidelines to make country more conversant with EU corporate governance requirements and recommendations.
4. To analyse situation with respect to corporate governance practices in the Turkish management culture by using the given parameters constitute remedies and recommendations to better comply with international best practices of corporate governance as well as EU corporate governance requirements and recommendations.
5. Finally, after comparing EU and Turkey corporate governance trends and issues, developing recipe for Turkey by using EU corporate governance as a model to facilitate access with current European best practices.

The first chapter of this study analyses the evolutionary process and importance of corporate governance phenomenon. It also addresses dimensions of corporate governance at both state and firm level. In this regard, an overview on international standards of corporate governance will be outlined by highlighting other domains in the achievement of corporate governance standards.

Second chapter broadly encompasses the implementation of corporate governance models within the EU in more details. Furthermore, in this chapter the recent developments on the basis of corporate governance are exhibited by emphasizing reforms and policies including recent developments on corporate governance practices. This chapter also tries to indicate differences as well as commonalities with respect to corporate governance in selected EU countries.

Next chapter focuses on investigating and highlighting characteristics of the Turkish corporate governance landscape and management culture by using the given parameters. In addition, dimensions of the corporate governance of Turkey are expressed within the context of recent developments with respect to corporate governance. In conclusion part, recommendations are constituted in response to the challenges and to remove chronic problems of the current corporate governance practices of Turkey by taking into account the Turkish accession process to the EU.

# 1. THEORETICAL ASPECTS OF CORPORATE GOVERNANCE PHENOMENON

## 1.1. Definition of Corporate Governance

Corporate governance is a phenomenon that articulated itself within a system which works in accordance with its elements and main principles. Also, the term corporate governance should be taken into extensively account with its legal, theoretical, social, and economical aspects that incorporated into a system which works in parallel to both national and international regulatory framework. It has also been major consideration with its various impacts and has taken significant place at the top of governments' agendas to a large extent in the last decade of twentieth century. In broader context, it has distinctive characteristics as well as commonalities that vary state by state which embedded itself as a core element within a country's legal and institutional context that entails a code of principles to become more effective. From this point of view, a number of institutions, Non-Governmental Organizations (NGOs), and international organisations such as OECD, International Chamber of Commerce (ICC), Global Corporate Governance Forum (GCGF), World Bank, International Monetary Fund (IMF) that focus on developing a guideline to take further steps in line with corporate governance regulations and standards.

In this context, there are so many approaches to describe the ways corporate governance operates. Broadly speaking, a well known definition of term corporate governance is described by OECD of which guidelines relating to corporate governance are widely accepted. The OECD focused on developing a set of corporate governance standards and guidelines in accordance with national governments, other relevant international organizations and the private sector addressing certain principles in implementing them. As has been explained in the OECD Report (2004) that: "Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (p: 11).

Indeed, good corporate governance system can only grow from an integrated system which provides close cooperation among executive authority, financial accounting, board

accountability and stakeholder aspirations to transparency (E.Hewkins, 2006:114). The key determinants of the corporate governance system are the strong integration of theoretical, economical and legal dimensions which entail strong integration to achieve high standards and sustainable economic growth for both developed and developing countries.

The other significant definition of corporate governance which is explained in the Cadbury Committee Report (1992): "Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that the appropriate governance structure in place" (p: 15). Taking into consideration above definitions, it would not be a right method to assume a universally accepted definition in respect of term corporate governance and to mention from one single code that fits all country. However, even so, it is an endeavor to seek common way through which both developed and developing countries as well as firms benefit from it in the achievement of best practices and to reach a success of a company in the long run. On the other hand, to have a better understanding the corporate governance mechanism that is driven by the help of its basic principles that are well known as the principles of transparency, accountability, fairness and responsibility.

As can be seen from the statements above, it is generally agreed that there is no common definition on term corporate governance. However, notion of corporate governance is frequently identified as a set of rules that used in balancing relations between various groups of interests like shareholders, stakeholders, credit providers, and customers. Besides, to provide sustainable economic growth, more investment and greater competitiveness successful implementation process of corporate governance system would come to the fore by establishing necessary regulations and good company law. As a whole, definition of corporate governance can be described as a system wherein exists correlative relationship and profound effect between internals and externals groups which constitute integral parts of the system.

## 1.2. Advantages of Good Corporate Governance System

In this chapter we will try to examine domains of good corporate governance that cherishes system at both state and firm level through which all firms and companies are directed and controlled in various ways including internals and externals pressure groups. Also, in this chapter it will be discussed that to what extent there exists the correlation

between good corporate governance and the market value both at state and company level by using surveys conducted in 2002 by *McKingsey*.

### 1.2.1. State Level

It can be seen that the importance and good practice of the corporate governance became dramatically clear at the beginning of the twenty-first century after a series of corporate scandals and collapses that have emerged due to managerial fraud, misconduct, and negligence which led to a massive loss of shareholder wealth and investor confidence. In this regard, in order to provide shareholders' rights, to restore investor confidence and to promote the value of their investment current corporate governance regulations have been necessarily considered to be developed. Also, so many questions have emerged for similar reasons as a big consideration after several corporate collapses such as investor confidence, shareholders rights, and employees who lost their jobs in business sector within the context of global trading and development. In attempt to response such corporate collapses and remove chronic problems the characteristics of "good" corporate governance were developed in *King Report (2002)* which has following aspects (pp.:10-11):

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

From this point of view there are several variables directly affecting corporate governance system in a country such as firm practices and level of capital market development. In this scope, the factors of countries consist of economic and financial circumstances, competitive market economy, well established and consolidated banking system that seem to be very crucial. As for to the factors related capital market that composed of market regulations and market liquidity, level of fulfillment of international standards, and best accounting standards. Furthermore, timely disclosure of financial and non-financial information, providing independence of board, equitable treatment of shareholder, participation of stakeholders in the decision making process, capital structure, and level of

free float and liquidity of stock are the key instruments which take place in the company practices (CMB of Turkey, 2003:5).

It is worth considering that in creating positive financial environment which provides state to increase their foreign investments and capital, good corporate governance system plays significant role to a considerable degree. After reaching better corporate governance standards, new structural regulations lead to increase number of foreign investors entering to the markets. Moreover, good corporate governance practices provide countries to better comply with international capital markets by improving relevant legal regulations. Since there are strong relation between economic growth and size of the country's capital market better corporate governance arises to serve this process with strong enforcement law and regulations.

As aforementioned, corporate governance brings following benefits and advantages at state level (CMB of Turkey, 2003:5):

**i.** Improvement of country's reputation,
**ii.** Prevention of outflow of domestic funds,
**iii.** Increase in foreign capital investments,
**iv.** Increase in the competitive power of the economy and capital markets,
**v.** Overcoming crisis with less damage,
**vi.** Efficient allocation of resources,
**vii.** Higher level of prosperity.

Considering empirical evidence and surveys conducted there is a strong relation between economic growth and size of the country's capital market. In that sense, countries of which corporate governance system enforced with strong company law and legal regulations wherein investor confidence becomes relatively high. For sure, this level of structuring creates high market value and economic performance in creation of foreign capital entering to the country. It has also effect to lower the cost of capital and lead to growth and economic development. Countries where exists weak corporate governance law and regulation , external finance is likely to be constrained and costly since financiers are less willing to provide financing because of the existence of insufficient financial environment and absence of investor protection. Taking into account research of *La Porta*, illustrates that countries which they tend to have stronger legal protections for minority shareholders they have larger securities markets, less concentrated share ownership and a higher value for minority shares

(Shalini, 2011:17). In a nutshell, there is a common belief which indicate that investors consider countries where exists effective and the establishment of rules for the protection of investor rights that enable to create positive financial environment in business community of a country.

### 1.2.2. Firm Level

It is no doubt that poor corporate governance and underdeveloped financial markets affect negatively growth and development. In a firm level-survey covering 54 countries, according to *Beck et al* it is agreed on that underdeveloped financial and legal systems and higher corruption affect the growth rates of the smallest companies. On the other hand, for *Levine and Zervos* it is widely accepted that lower stock market development is likely to reduce growth. Besides, it should be remembered that corporate governance plays significant role with its effect on firm valuation as well as the development of financial markets. Similarly, higher firm value gives rise to more attractive investments for investors in business world (Shalini, 2011:17).

On the other hand, in order to confirm good corporate governance positive effects and to estimate the correlation between good corporate governance and the market valuation of the company at state level, a number of surveys have been conducted in 2002 by *McKingsey*. He conducted the survey between 188 companies from 6 emerging markets covering India, Malaysia, Mexico, South Korea, Taiwan and Turkey to measure that who hold divergent positions on corporate governance practices whether there is any considerable connection between good corporate governance and the market valuation of the company. The results of the survey pointed out a positive correlation between these two variables. Briefly, good corporate governance increases market valuation in the ways noted below:

- Increasing financial performance,
- Transparency of dealing, thereby reducing the risk that boards will serve their own self interest,
- Increasing investor confidence.

In addition to these factors, *McKingsey* assesses the performance of corporate governance of company that based on the factors of accountability, disclosure and transparency, and shareholder equality. Thanks to the survey, *McKingsey* reached results those companies with good corporate governance practices lead to high price-to-book values

for which investors are willing to pay a premium for the shares of a well-managed and governed company (Fernando, 2006:84). In short, in order to get benefits from good corporate governance companies fulfill all necessities to attract investments which cherish market valuation for sustainable economic growth. In a nutshell, companies can have benefits and advantages through following aspects (CMB of Turkey: 5):

- Low capital cost,
- Increase in financial capabilities and liquidity,
- Ability of overcoming crisis more easily,
- Prevention of the exclusion of soundly managed companies from the capital markets.

Consequently, it is important to highlight that as countries have well and effectively governed firms which increase higher firm value that bring suitable financial environment which let attractive investments go beyond for country. In case of countries have underdeveloped financial markets and poor governance system that lead to rather less limited investment environment; they need to be more integrated for the creation of better governance. As a result, effective and good corporate governance practices would only be achieved by improving related rules and regulations to reach high standards. In sum, to take further steps for firms to reach good corporate governance practices this entails not only establishment of rules but also requires corporate governance codes to be applied.

### 1.3. An Overview on International Standards of Corporate Governance

It is important to take note that the starting point of good corporate governance is to response to the challenges that occurred after several corporate collapses which have had an adverse effect on shareholders, employees, companies, and governments on a large scale. Considering results of the bad corporate governance practices leading to corporate collapses and scandals one should take into account reasons why these collapses occurred. It is therefore, in order to reach high standards for good corporate governance practices, the principles and guidelines have been originally developed respectively by OECD and other relevant international organisations such as the International Corporate Governance Network (ICGN), Commonwealth Association for Corporate Governance (CACG), and World Bank. Next chapter deals with the contributions of organisations in more details.

### 1.3.1. OECD Principles of Corporate Governances

It is clear that corporate governance scandals have major influences on financial investment of shareholders, employees who have lost their jobs, and the economic impact on government including companies (Christine, 2010:1). Considering corporate collapses emerged in UK, USA, Europe, Australia, Singapore, and India one can clearly comment the reasons that deriving from bad corporate governance structures and practices that they have had (Christine, 2010:6-7):

- Lack of effective internal controls and inadequate supervision (Baring Bank, England).
- Members of the family take a dominant role across board structure as a whole, lack of independence of boards and a lack of timely disclosure of information (Parmalat, Italy).
- A corporate governance structure that had empowered Chief Executive Officers (CEOs) and that led to Royal's demise (Royal Ahold, Nederland).
- State-Owned subsidiaries including those operating outside China (China Aviation Oil, China).
- Giving misleading information by some board members with the intension of deceiving the company's auditor (HIH, Australia).
- Difficulties to question and limit the activities of a powerful CEO (Royal Bank of Scotland, Scotland).
- A lack of disclosure and accountability by boards that led to some adverse effect on minority shareholders (Satyam Computer Services, India).
- Non-existent of integrity in business, in particular for the directors to act with integrity and honesty, and for the external audit firm to be able to ask searching questions of the directors (Enron, USA).

As can be seen from the statements above, all corporate failures led to some challenges in providing investor confidence and a lack of effective corporate governance. In order to avoid such collapses and restore investor confidence again one should take into consider reasons why those collapses occurred. In that sense, in order to reach good corporate governance standards several steps have been developed by international organizations and networks such as OECD, the ICGN, the International Chamber of Commerce (ICC), the GCGF, and the CACG in addition to International Monetary Fund (IMF) and World Bank. The OECD however, plays key role in solving challenges by developing agendas compared to

other international organizations. The guidelines of corporate governance of the OECD are widely accepted that addresses certain principles in implementing them (Gönençer, 2008:33-34). However, considering the contributions and functionality of the OECD clearly differs from other international organizations dealing with the corporate governance issue for advancing standards in long run.

Despite the fact that the principles focus explicitly traded companies, they can be used also non-traded companies as a supporting and developing tool to improve corporate governance practices. The OECD principles broadly encompass a great deal of Principles and Recommendations to assist OECD and non-OECD countries to enhance their legal and institutional structure under the regulatory framework. Essentially, the principles encourage the governments to adopt common principal in the achievement of good corporate governance practices. Moreover, in order to provide high degree of confidence which is essential for well established market economy, it can be only achieved through an effective and well governed corporate governance system (OECD, 2004:11).

In addition, in order to be effective in respect of disclosure and accountability the OECD also considers two key elements of corporate governance by establishing two regional bodies which entitled as the International Regional Federation of Accountants and Auditors in Eurasia (IRFAA) and the South Eastern European Partnership on Accountancy Development (SEEPAD) (Gönençer, 2008:35). Furthermore, the OECD Principles brings relatively influential Recommendations to be transposed into national law to apply voluntarily by the OECD Members. However, considering the legal context of principles which was formed as non-binding it depends on governments and market participants to adopt and to implement them in enhancement of their corporate governance framework. In sum, main principles of OECD encompasses following aspects (OECD, 2004:14):

- The rights of shareholders,
- Equitable treatments of shareholders,
- The role of stakeholders in corporate governance,
- Disclosure and transparency,
- The responsibilities of board.

Frankly, the main role of the OECD substantially is to assist and consult not only to the national governments of member states but also private sector as well as different international organisations. In its essence, the OECD emphasizes that “one size does not fit

all" which means there is no single model of corporate governance that is widely accepted by all countries across the world. However, the principles imply common features that are to be considered fundamentally for good corporate governance (Christine, 2010:37).

### 1.3.2. World Bank

As has been took place in the agenda of OECD, the main corporate governance aspects occupy also important place of World Bank agenda which are known; the right of shareholders; the equitable treatment of shareholders; the treatment of stakeholders; disclosure and transparency; the duties of board members. World Bank gets benefits from the principles of OECD in the creation of good corporate governance practices. It also works in accordance with the countries in the achievement of its priorities which needs high standards of corporate governance to success better implementation. In so doing, the World Bank makes a great deal of contribution assessing the corporate governance institutional frameworks of the countries at international level.

In addition to the World Bank activities regarding corporate governance practices, the IMF prepares reports which comprise the development of standards and codes in implementation of corporate governance practices. Main purpose of this report is to indicate that to what extent the countries fulfil international standards and codes of corporate governance practices. As for to the activities of the GCGF of which main role is to secure close co-operation among OECD and World Bank bringing together various groups, organisations, the private sector representatives, and bodies that try to crate presence of good corporate governance standards. Furthermore, the GCGF plays important role like other organisations to "promote global, regional and local initiatives that improve corporate governance policy standards and practices in developing countries" (Christine, 2010:39).

### 1.3.3. International Corporate Governance Network

The fundamental function of the ICGN is to deal with development of corporate governance issue involving various actors and groups at global level. In other words, its main role is to provide close co-operation and dialogue among these actors and groups on the basis of corporate governance standards. In addition, the ICGN published its principles in 1999 which consist of three main areas under the name of *Statement on Global Corporate Governance Principles*. According to these areas, the first statement clearly encompasses ground of standards on corporate governance which is acceptable for companies and other

groups all over the world. Second statement however, deals with OECD principles including ten areas. In the third statement, the ICGN substantially extends the OECD principles. Besides, the ICGN published the global corporate governance principles in 2005 by taking into account of the OECD principles that has been revised in 2004. Its published and revised principles highlight a number of new principles that comprises eight areas including the ICGN and its members. Moreover, the CACG makes a huge amount of contribution for creation of presence of good corporate governance practices by developing guidelines and principles encompassing fifteen principles in more details including board's role and responsibilities (Christine, 2010:40-41).

### 1.3.4. Development of the Corporate Governance Codes

It is widely known that the necessity of corporate governance code became very important after emerging several financial crisis and corporate collapses or for similar reasons in order to create presence of more transparency, accountability and investor confidence in financial market. In that respect, a number of countries considered to adopt new regulatory changes into their domestic law and political context. It is therefore, the *Cadburry Report (1992)* which was developed in the United Kingdom (UK) such as the *Sarbanes Oxley Act (SOX)* which entered into forced in 2002 to raise standards of corporate governance in USA, can be shown as an example in addition to the OECD principles that led to increase several corporate governance codes in many countries. Thus, the starting point of corporate governance code is to force both governments and companies in fulfilling them in order to create good corporate governance standards (Christine, 2010:25-26). In particular, in the UK there have been performed several developments for moving beyond with regard to development of corporate governance codes which had fundamental effect on the development of corporate governance in several countries, particularly *Cadbury Report (1992)* through which the first version of the UK code on Corporate Governance came into existence. To sum up in the UK, the implementation of corporate governance code depend heavily on the "comply or explain"[1] mechanism that entails soft law rather than forcing legally binding or having force of law. In other words, it is highlighted to be applied voluntarily by the governments in order to introduce and develop corporate governance codes.

[1] According to Corporate Governance Code of the UK, it is mainly used as a trademark of corporate governance in the UK which is supported by both companies and shareholders.

## 1.4. Models of Corporate Governance

Mainly, the models of corporate governance are distinguished into two corporate governance models which are called “outsider system” which is used in Anglo-Saxon countries, and “insider-system” that is mostly used in Continental Europe. Additionally, there are two corporate governance models which can be identified as Rhineland (Germanic) and Latin system as sub-elements of the corporate governance models. This chapter largely focuses on both the “outsider system” and “insider-system” structures that let us to make a theoretical classification between them in connection with corporate governance system.

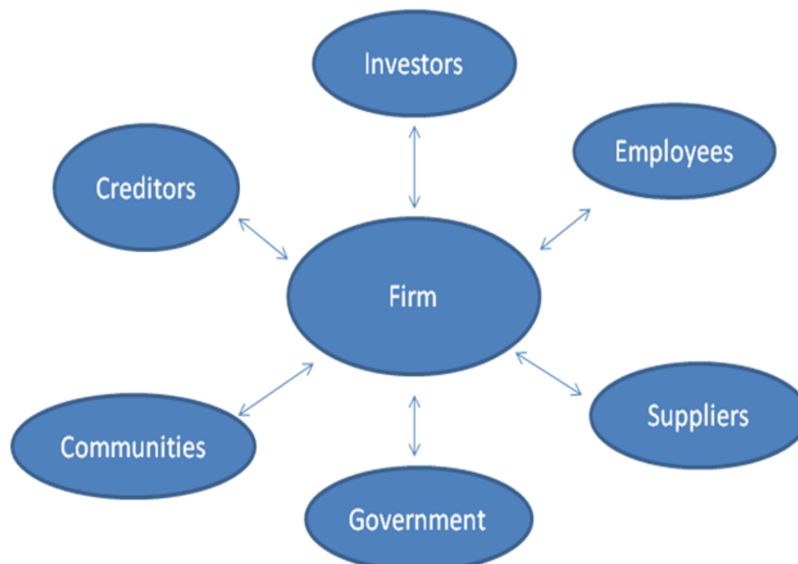
### 1.4.1. Insider Model

Essentially, this model is primarily concerned with a socially economy where the role of the stakeholders become more effective which mostly prevalent in Continental Europe. Also, in this model the role of the firm takes precedence over the shareholder value and the countries having an insider system where companies tend to have a concentrated ownership structure. This system substantially characterised by stakeholders where equity and corporate bond markets remain rather limited in comparison with the “outsider-system”. Since this system has been oriented to prioritize the interests and wealth of all stakeholders of the company in contrast to outsider-model, it is therefore pronounced generally as social model which is mostly used in Continental Europe. Moreover, in this model banks take significant place at the centre of the system and shareholder can be positioned at this system as a fostering element and major creditor of the firm (Van den Berghe, 2002:11). In some of the countries having an insider-system where family and industry interests become more effective as well as banks and holding companies. Besides, due to existence of suitable communication among insiders this leads to make precedence of them clearer to monitor of the corporate management (Gönençer, 2008:21). Furthermore, the insider model has the following significant features:

- Significant role of the banks as major creditor of company,
- Complexity of the board structure,
- High importance of the interests of all stakeholders,
- Concentrated ownership structure,
- “Network-oriented” system between controlling block holders,
- Low markets confidence.

The structure of the "insider-model" is shown in below Figure 1.1:

**Figure 1.1: Insider (Stakeholder) Model**




**Source:** SCHEIFER, A., VISHNY, R. A.; "Survey on Corporate Governance", National Bureau of Economic Research Working Paper, 1994. Cited in: A.Osman Gürbüz, Yakup Ergincan, 2004, "Kurumsal Yönetim: Türkiye'deki Durumu ve Geliştirilmesine Yönelik Öneriler, p.11

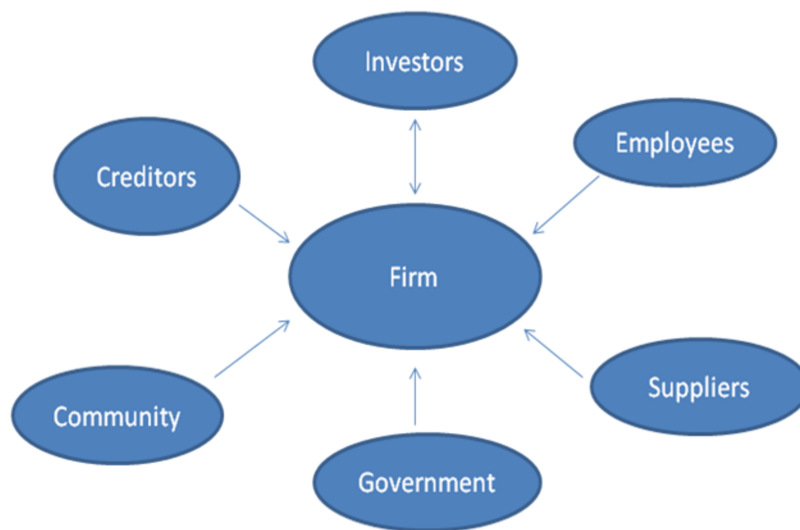
Besides abovementioned statements, there are several drawbacks of the insider system which derive from its characteristics pertaining to internal logic of the system. As noted above, there is an effective role of the banks in this model which play twosome role of shareholder and major creditor. Since there is a strong link between concentrated ownership and control requisition may cause decreasing the growth potential of companies. This level of activity gives rise to conflict of interest since banks intent to decrease the risk taken by the corporation. This risk can potentially reduce the number of investment undertaken by the firm. As a consequence, firms tend to explicitly have a concentrated ownership structure leading to lose growing potential as well as getting benefits from globalisation and economic integration (Van den Berghe, 2002:11-12).

### 1.4.2. Outsider Model

The outsider system is widely used in USA and UK that is mainly known as "Anglo-American "system. This system is extensively pronounced as "market-oriented "system. In this system, main purpose of the firm is primarily to ensure the maximisation of shareholder value. In other words, this system is characterised by maximising shareholder value and financing for which equity and corporate bond markets are used in contrast to the "insider-

model". In this model, the directors and managers are responsible to direct and oversee for protection of shareholder interest and increasing their wealth. Furthermore, this system highly encompasses strong market securities by creating suitable market confidence and positive financial environment where exists equal access to information and high level of protection of small investors. As for to the board structure in the "outsider-system" in which members are appointed or dismissed by general meeting of shareholders, consists of both executive and non-executive board directors (Van den Berghe, 2002:9). The "outsider-model" is shown in below Figure 1.2:

**Figure 1.2: Outsider (Shareholder) Model**




**Source:** SCHEIFER, A., VISHNY, R. A.; "Survey on Corporate Governance", National Bureau of Economic Research Working Paper, 1994. Cited in: A.Osman Gürbüz, Yakup Ergincan, 2004, "Kurumsal Yönetim: Türkiye'deki Durumu ve Geliştirilmesine Yönelik Öneriler, p.11

The "outsider-model" encompasses following main characteristics (Gönençer, 2008:16):

- Precedence of shareholder wealth and value for the firm,
- Prevalence of dispersed ownership structure,
- Absolute and clear existence of separation of owners and management,
- High disclosure standards,
- Protection of minority rights and small investors,
- Tendency to use equity and corporate bond markets.

## 1.5. Summary

It is worth noting that the term corporate governance has substantially gained a great deal of attention in the public debate and became important for business world in the last decade with its multi dimensional effects and results. It is worthwhile and indeed essential to take note that it is impossible to observe that the existence of identical and single corporate governance model that fits all countries since each country has different cultural, legal, and institutional context. However, even so, in order to adopt international governance standards, the principles can be addressed which imply common features that should be considered fundamentally international governance standards for applying good corporate governance practices. In this respect, countries can reach high standards by articulating international governance standards within its own legal, cultural, and institutional context on the basis of corporate governance practices to constitute its unique and specific corporate governance model.

Given corporate governance collapses and financial scandals and anything else strengthening and developing current corporate governance standards owe its credits to the corporate governance collapses that exposed to face considerable challenges that made necessary to make recommendations for the creation of good corporate governance standards in business community. In this context, in order to reach good corporate governance standards several international organizations and networks were established to find solutions and to set rules in response to the challenges. However, the OECD is widely known considering its crucial role in solving problems by constituting guidelines and making recommendations in compared to other international organizations such as ICGN, ICC, GCGF, CACG, IMF and World Bank. Accordingly the guidelines of corporate governance of the OECD are widely accepted on a large scale which addresses certain principles for fulfilment them.

Considering models of corporate governance which let us to draw a picture from a different angle and systematic perspective by comparing differences as well as commonalities among countries which having corporate governance systems used regarding corporate governance practices. The other important issue is that should be highlighted assuming the possibility of whether there is a strong link between economic growth and size of the country’s capital market by taking into consideration empirical evidence and surveys conducted. In this respect, countries of which corporate governance system enforced with strong company law and developed the integrity of the judiciary system wherein investor

confidence becomes more effective. Briefly, investors consider countries where exists effective and successful governance structure thereby they are more willing to pay a premium for the shares of a well-managed and governed company.

# 2. CONCEPTUAL AND THEORETICAL FRAMEWORK OF CORPORATE GOVERNANCE IN THE EUROPEAN UNION

## 2.1. Modernizing of European Union Corporate Governance Structure

It is widely believed that the European Commission (EC) plays significant role by developing relevant directives, regulations as well as guidelines. It is also known as an issuer and key actor in fulfilment of EU best corporate governance practices. Moreover, it is notable that the legal nature of the EU corporate governance system was based on social model which was clearly emphasized in the Lisbon Agenda. In other words, it focuses on taking on a larger role for carrying out in the field of corporate governance policy driven by the concept of social model of corporate governance. Within this regard, in order to strength corporate governance and to provide greater competitiveness the EC took action by issuing a communication under the name of "Modernizing Company Law and Enhancing Corporate Governance in the European Union-A Plan To Move Forward" in 2003 which is called also *Company Law Action Plan (CLAP)* (Gönençer, 2008:50). The focal point of the Action Plan is to remove all barriers and drawbacks leading to lack of public confidence in financial markets where new company law and corporate governance framework seen as an absolute necessity for the existence of best EU corporate governance regulatory umbrella. The reasons why these challenges occurred and current EU corporate governance regulations and company law needs to improve outlined in the following statements (The EU Approach to Corporate Governance, 2008:3):

- Adverse effects and drawbacks of recent financial scandals,
- The integration of European capital markets,
- The trend of European countries to engage in cross-border operations in the Internal Market,
- The rapid development of new information and communication technologies,
- The increase of Member States to the European Union.

Notwithstanding, in order to move current corporate governance practices beyond the significant step has been taken by the EU High Level Group of Company Law Experts in 2001 for modernizing company law within the EU with regard to corporate governance requirements. This group is also known as *Winter Group* that consists of a group of lawyers that was established in 2002 for developing EU company law. Since the group was chaired by

Jaap Winter it is called as the *"Winter Report"*[2] *(2002)*. In addition to the abovementioned statements, the Action Plan which has been reviewed in 2006 by the EU Commission aims at dealing with the shareholders' rights and obligations, internal control, and the modernization and simplification of European Company Law. Also, in 2007 the Commission published two reports to focus that to what extent the Member States conduct Recommendations on independent directors and directors' remuneration. The report also considers that most of corporate governance codes issued to be used by all Member States through "comply or explain" basis (The EU Approach to Corporate Governance, 2008:4). Another important issue is that the proportionality which was published by the EC broadly encompassing relationship between capital and control by addressing the concept of "one share one vote".

### 2.2. Setting European Union Corporate Governance Standards under the Legal Aspects

As it is clearly known that the EC is the most important key player to achieve best practices of EU corporate governance regulations. Within this scope, the legal context of the EU corporate governance practices was based on social model concept which occupies significant place of the Lisbon Agenda. In that respect, the EC takes initiatives in the creation of best EU corporate governance and fulfils its main mission by exerting key instruments such as Directives, Recommendations and Regulations. It also stimulates and fosters Member States, EU candidate and potential candidate countries in order to better comply with EU corporate governance standards. From this point of view, in order to set international standards and practices of good corporate governance, developing and updating corporate governance codes are seen extremely essential. Since development of the corporate governance code is seen highly necessary by the EU, the EU encourages Member States to adopt corporate governance codes. Therefore, the existence of the corporate governance code within the EU play highly significant role in creating presence of further convergence between Member States to success better practices of good corporate governance.

Besides all above, in 2006, national corporate governance codes occupied significant space in the agenda of the European Union Corporate Governance Forum (EUCG Forum) of which main purpose is to emphasize the necessity of corporate governance codes to be applied through "comply or explain" mechanism. However, it can be achieved providing that through the availability of relevant regulations in line with shareholder rights and the integrity of the judiciary and the legal system. In this regard, considering the 2006 Directive requires listed

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[2] For details, see 2.3.2. Winter Report

companies to publish annual corporate governance code that is to be applied by the company and to explain degree their compatibility with this code (The EU Approach to Corporate Governance, 2008:5). Moreover, since the main objective of the EC is to encourage the further convergence of corporate governance national codes through a dynamic and flexible framework for company law within the EU. Furthermore, the working mechanism of the CLAP is mainly shaped by the Winter Group referring to its recommendations. The CLAP concentrated on following six main areas (Gönençer, 2008:50-51):

- Corporate Governance,
- Capital maintenance and alteration,
- Groups and pyramids,
- Corporate restructuring and mobility,
- Other matters.

### 2.2.1. Board of Directors

Taking into consideration directors' remuneration for which a comprehensive document was adopted in December 2004 under the name of the EC Recommendation that fosters an appropriate regime for the remuneration of directors of listed companies (Commission of the EU, 2004). Mainly, the recommendation strongly addresses the four noteworthy measures to be adopted by the Member States (Commission of the EU, 2007:4-5):

- Disclosure of remuneration policy,
- Shareholder's vote on remuneration policy,
- Disclosure of the remuneration of individual directors,
- Prior shareholder approval of share and share option schemes.

The starting point of this Recommendation on directors' remuneration is to require Member States that listed companies should disclose their policy concerning directors' remuneration in more details including income of individual directors. Moreover, it encompasses the necessity of remuneration policy whether it occupies extremely significant place in the agenda of shareholder's meeting concerning remuneration policy. Furthermore, directors' remuneration issue was emphasized in the Action Plan, which was reviewed in 2007 by the EU Commission with respect to corporate governance that was developed for listed companies. Briefly, the Commission's 2004 Recommendations on directors'

remuneration comprises the following features (The EU Approach to Corporate Governance, 2008:7):

- All listed companies should publish an annual statement covering its remuneration policy and should disclose it at Website,
- The statement published should encompass contract details including terms, periods and payments,
- The remuneration policy should be voted on by shareholders,
- Incentive share based schemes for directors should be subject to prior shareholder approval,
- Individual directors should disclose in case of they granted benefits and remuneration in the annual accounts.

As to the board composition for which the Recommendation was published by the EC entitled as on the role of non-executive or supervisory directors of listed companies and on the committees of the board in January 2007 (Commission of the EU, 2007). The main purpose of the Commission's Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the supervisory board is to provide high standards and to create presence of adequate guarantee of independence of the boards of listed companies. It also focuses on preventing conflicts between various groups of interest that derives from management decisions to be taken independently (The EU Approach to Corporate Governance, 2008:5).

The main principles of the Recommendation are addressed in the following statements (Commission of the EU, 2007:4-5):

- Separation of the role between chief executive director and supervisory board chairman,
- Sufficient number of independent directors on the supervisory board,
- Creating presence of board committees focusing on issues increasing conflict of interest,
- Strong presence of independent directors in board committees and precisely statement of the role of such bodies,
- Providing transparency on independent board members,

- Enabling high standards on qualifications and commitment of supervisory board members.

### 2.2.2. Disclosure and Transparency

In order to provide disclosure in relation to the corporate governance arrangement within the EU Council Directives *78/660/EEC* on the annual accounts of certain types of companies was amended by Directive *2006/46/EC* in 2006 that necessitate Member States to disclose of an annual corporate governance statement (Directive 2006/46/EC of the European Parliament and of the European Council, 2006). The new Directive also provides a clear delineation of the responsibilities of the auditors and creates presence of their independence. Moreover, the term “public interest entities” has taken place in the *Article 41* that broadly encompasses listed companies, credit institutions and insurance for which audit committee' functions become more apparent to be undertaken initiative when necessary. The audit committee' functions consist of financial reporting process, the effectiveness of internal control, internal audit, risk management systems, the audit of the accounts, and the independence of the auditor (The EU Approach to Corporate Governance, 2008:9). Taking into consideration Transparency issue which takes part in the EU legislation of the Transparency Directive that was updated in 2005, it largely concentrates on developing the quality of information provided for investors regarding companies' performance. Furthermore, the Directive requires to implement necessities; both periodic financial reporting and disclosure of major shareholdings. Another important point is that the new Transparency Directive necessities may create the presence of liability of a listed company including its directors, and auditors by taking into account for the accuracy of the company's financial reports (The EU Approach to Corporate Governance, 2008:9-10).

### 2.2.3. Shareholder Rights

In order to enhance shareholder rights, in particular in facilitating cross-border voting exercise, the Directive on the exercise of certain rights of shareholders in listed companies strongly recommends timely access to information for shareholders and facilitating the exercise of voting at a distance was issued in 2007 to be implemented by 2009 (Directive 2007/36/EC of the European Parliament and of the Council, 2007). Furthermore, according to an external study published by the Commission that encompasses proportionality between capital and control in EU for listed companies. In this context, the proportionality concept

aims at dealing with relationship between capital and control by using "one share-one vote" principle and the external study conducted by Institutional Shareholder Services Europe (ISS Europe), the European Corporate Governance Institute (ECGI), and the law firm Shearmen & Sterling LLP. Taking into consideration the proportionality principle the ISS Europe, ECGI and the law firm Shearmen & Sterling LLP reached that (Christine, 2010:42):

> (...) on the basis of the academic research available, there is no conclusive evidence of a causal link between deviations from the proportionality principle and either the economic performance of listed companies or their governance. However, there is some evidence that investors perceive these mechanisms negatively and consider more transparency would be helpful in making investment decisions.

The key provisions of the Directive outlined in the below statements:

- It provides the possibility of shareholder to ask questions and to receive answer from the company,
- It provides enhancement the shareholders rights extending rules on transparency, proxy voting rights, participation in general meeting via electronic means and the possibility of cross-border voting rights to be applied,
- It necessitates to remove all barriers which creates absence of shareholder activism and leads to ineffective shareholder control that seems to be very essential for sound corporate governance,
- It ensures shareholders facilitating the exercise of voting regardless of their distance in any case,
- Voting results should be disclosed on the company's web site to be made transparent,
- It enables the possibility access to information for non-resident shareholders to the general meeting and the exercise of voting rights without physically attending the general meeting.

### 2.2.4. Audit Independence

With regard to audit independence which is seen highly crucial for the credibility of published financial information and for capital markets of the EU. Therefore, the EU's 8th Company Law Directive *(84/253/EEC)* was issued by the Commission. The main purpose of the Recommendation is to provide harmonisation of auditor independence as much as

possible within the EU (Directive 2006/43/EEC of the European Parliament and of the Council, 2006). The key development on Communication was for the creation of a Committee on Auditing that entails close co-operation between accounting profession and Member States. This communication mainly describes auditor independence which is called as a core element to develop further action. Moreover, the directive broadly stress that the auditors cannot act unless specified their independency. In sum, the Recommendations aim at dealing with following specific issues (Recommendation on Auditor Independence, 2002):

- Financial interests,
- Business relationships,
- Employment with the audit client and the audit firm,
- Managerial or supervisory role in the audit client and
- Family and personal relationships.

Besides abovementioned, this Recommendation facilitates to exercise the Member States that the possibility of going further from proposed approach. Another significant point is that this Recommendation was issued by the Commission through a Recommendation which has a non-binding act rather than a Directive.

## 2.3. Enhancing European Union Corporate Governance through new Regulatory Framework

This chapter deals with three significant elements that are known respectively as *Lamfalussy* Report, *Winter* Report and Lisbon Agenda which can potentially enhance the EU's corporate governance standards by improving regulatory framework through the new regulations and requirements at EU supranational level.

### 2.3.1. *Lamfalussy* Report

It is clearly known that the effective and strong financial market mechanism is seen most essential for the EU economy as well as integration that entail well established and consolidated legal systems in line with EU's financial markets. Therefore, the main objective of the Lamfalussy Report is to enhance and improve EU's financial services regulation encouraging close cooperation between Member States within the EU. Furthermore, this development was undertaken by *Alexandre Lamfalussy* and driven by the group entitled "Committee of Wise on the Regulation of European Securities Markets" (Lamfalussy Report, 2001). Essentially, in order to secure market security it aimed to remove all barriers leading to

ineffective corporate governance mechanism in the EU. It also enable Member States to act timely and respond rapidly to changes in connection with corporate governance requirements particularly in helping to restore confidence in the markets within the EU. As a whole, the factors leading to challenges and obstacles in developing European market securities are addressed in the following statements (Lamfalussy Report, 2001:10):

- The absence of clear Europe-wide regulation on a large number of issues preventing the fulfilment of the mutual recognition approach,
- Existence of an inefficient regulatory framework,
- Instable exercise deriving from lack of an agreed interpretation of the rules that do exist,
- The insufficient development of funded pension schemes that exist most of Member States,
- A large number of transaction and clearing and settlement systems that fragment liquidity and increase costs.

Considering abovementioned statements, *Lamfalussy* Report mainly focuses on ensuring an integrated financial market by providing broad consensus within the EU. It also aims at removing all barriers that relatively damages and prevents rapid integration of EU financial market. Generally, the *Lamfalussy* Report aims at providing EU market securities by amending necessary rules and regulations that are seen extremely needed to be altered.

### 2.3.2 Winter Report

In addition to the *Lamfalussy* Report, the Winter Report focuses on improving company law and deals with how to enhance European corporate governance standards. It mainly addresses the need for modernizing of company law in Europe through the new regulatory framework in terms of corporate governance requirements. In this context, the "High Level Group of Company Law Experts" which is called also as Winter Group, aims to constitute recommendations and to change company law by taking initiatives with regard to EU corporate governance regulations. Before getting into details relating to Report published by the "High Level Group of Company Law Experts", it should be highlighted that the specific areas of the Report prioritises following key areas (Winter Report, 2002:27):

- the creation and functioning of companies and groups of companies, co-operatives and mutual enterprises,

- shareholders' rights,
- corporate restructuring and mobility,
- the possible for new legal forms,
- the possible simplification of corporate governance rules.

Moreover, the establishing group came together to develop a report that broadly encompasses a number of recommendations for listed companies providing independent advice for modernizing company law in Europe. Following statements constitutes recommendations in relation to corporate governance issues (Christine, 2010:41):

- EU law should impose companies to be published an annual corporate governance statement in their accounts and on their websites. Companies would need to state their compatibility with their national corporate governance code with reference to "comply or explain" mechanism,
- As to the nomination and remuneration of directors, and the audit of accounts which should be decided upon by non-executive, or supervisory, directors, the majority of whom are independent,
- Companies should also disclose in their annual corporate governance statement their independent directors and reason why they are independent and it should also be stated that their qualifications are to serve on the board,
- The remuneration of individual directors should be disclosed in detail,
- Concerning the general meeting, companies should be required to publish all necessary documents on their website and facility of electronic voting should be offered,
- Companies should inform shareholders of the procedure for asking questions at general meetings, and also for submitting shareholder proposals,
- Share option schemes would require the prior approval of the shareholders.

In the achievement of abovementioned key priorities a consultative document is needed which has been published by the group that play highly significant role for the creation of better company law in Europe concerning corporate governance practices. Generally speaking, the focal point of the Winter Report is highly depends on creating the modern regulatory framework regarding company law within the Europe.

### 2.3.3. Lisbon Agenda

It is clearly known that the Lisbon Strategy was developed by the EU Council in 2000 in to response to negative effects of globalisation and ageing problems, economic crisis and unemployment issue that occurred within the Europe due to enlargement of the EU. Also the Strategy mainly highlighted necessities to enhance its standard of living and sustain its unique social model by providing greater growth. Furthermore, the main purpose of the Lisbon Strategy occupied significant place in the agenda as key word "*to become the most dynamic and competitive knowledge-based economy in the world by 2010 capable of sustainable economic growth with more and better jobs and greater social cohesion and respect for the environment*". In this respect, the Lisbon Strategy primarily focused not only on improving sustainable economic growth but also developing social inclusion by securing strong social cohesion within the Union whilst struggling to eliminate social exclusion.

In order to provide sustainable economic growth and sustainable development in the Europe which are seen extremely significant for the creation of more jobs and more investment, therefore the word competitiveness became key word of the Lisbon agenda. Thus, the basic objective of the Lisbon Strategy expressly encompasses various components in the achievement of goals which intertwined with its core elements together to be fulfilled them in pursuing strategy, in particular in providing sustainable economic growth whilst promoting EU's social model principle at the same time. In the light of above one can clearly state that in the achievement of goals and objectives described in the Lisbon Agenda, the strong emphasis of the European Social Model of corporate governance is fundamental to advancement of the uniquely European approach which was strongly stressed by the EC in 2004 in the following statements:

> (...) we need to restore investor confidence in Europe's ability to create the conditions to meet its objectives. Europe can build on its rich tradition and diversity, its unique social model and draw from its recent enlargement which makes it largest single market and biggest trading block in the world (European Commission, 2004).

In addition to abovementioned statement, the fundamental device to entrench its corporate governance approach which entails adoption of European Social Model in a broader context that expressly stated as noteworthy goals and objectives in the Lisbon Strategy indicated as follows:

(...) the Lisbon Agenda must be owned by all stakeholders at EU, national, regional and local level; Member States, European Citizens, parliaments, social partners and civil society and all Community institutions. They should all contribute to construct Europe's future (COM (2005) 24/ Final).

Evidently, this statement expresses the fundamental objectives of the Lisbon Strategy as well as its distinct corporate governance model of EU depending significantly on European Social Model mechanism which broadly emphasizes stakeholders' values such as suppliers, credit providers, employees, customers alongside shareholder value. On the other hand it lets us to draw a picture in a comparative context and proffers us considerable details from a number of different perspectives pertaining to its corporation concept that dramatically embraced within the EU and clearly differs from those of other governance systems, particularly Anglo-American system, which extensively relies on shareholder model.

## 2.4. Corporate Governance in Selected Western European Countries: Convergence or Divergence?

This chapter predominantly considers and deals with both the conceptual and theoretical framework of the corporate governance models and implementations in the some selected Western European countries respectively Germany, France, Italy and United Kingdom by taking into account fundamental and distinctive characteristics of corporate governance. Also, considering the implementation of corporate governance in selected countries, the assessment will be strongly made by using given parameters within a broader comparative context.

### 2.4.1. Germany

Before getting into details relating to German corporate governance system one needs to make a descriptive analysis of components of the German corporate governance system and to draw a picture from different angle. Therefore this part mainly considers the German corporate governance structure and examines the basic idea behind the German corporate governance system.

#### 2.4.1.1. Structure of German Corporate Governance System

Taking into consideration fundamental elements and characteristics of German corporate governance system, one can clearly analyse that the German corporate governance

system is mainly characterised by insider-model or “stakeholder-oriented” system which significantly emphasizes stakeholders that based on Bank centred system. Besides, the role of the firm takes precedence over the maximising shareholder value. In other words, it seems to arise from a legal tradition since the inception of the 1920s that extremely prioritizes and concentrated on interests of all stakeholders rather than maximising shareholder value (H.Schmidt, 2003:1-2). Since strong networking articulated itself as a central element within this system which is mostly seen between controlling block-holders this is why this model is mostly recognized as “network-oriented” system.

In assessing German corporate governance system relies significantly on determining factor that is widely known German Stock Corporation *Aktiengesellschaft* which can directly affect basic characteristic and legal structure of the German corporate governance system alongside with the *GmbHs (Kapitalgesellschaften).* The Stock Corporation Act *(Aktiengesetz)* provides power by means of management board undertakes responsible in providing consistency stakeholder interests with German company law (H.Schmidt, 2003:8). However, it should be noted that only *AGs* are legally dominant in listing on a stock exchange in the equity markets and they mostly have large block-holders that they have potential to affect monitoring of listed firms. Taking into organizational form of the German governance account it is obvious that company statutes and contractual relations clearly distinguishes between owners and stakeholders as imperative and non-imperative legal norms. In this context, *Vereine* (Unions) and *Stiftungen* (Foundations) are extensively preferred as organizational forms of large enterprises. For instance, all soccer clubs can be categorized as a *Verein* while dominant stakeholders classified by the *Stiftungen* concept (Gugler, 2001:97).

#### 2.4.1.2. Basic Characteristics of German Corporate Governance

Considering factors closely affecting and shaping features of German corporate governance system one might address that the EU necessary regulations and requirements in line with corporate governance and capital markets that arising from *acquis communitaire* which is essential part of the EU integration. In this respect, to become a Member of the EU exposed Germany to face convergence of a good corporate governance system within the Union and adoption of the European social model of corporate governance in the achievement of sustainable economic growth and competitiveness. Therefore, with the help of the necessary legislation and regulation *(acquis communitaire)* EC tries to encourage its Member States for convergence in fulfilment of its social model.

**Table 2.1: Key Characteristics Influencing German Corporate Governance**

| Feature | Key Characteristics |
|---|---|
| **Main business form** | Public or private companies limited by shares |
| **Predominant ownership structure** | Financial and non-financial companies |
| **Legal system** | Civil law |
| **Board Structure** | Dual |
| **Important Aspect** | Compulsory employee representation on supervisory board |

**Source:** A.Mallin, Christine, 2010, Corporate Governance, Oxford University Press, p.216

As to come to assessing of German corporate governance board structure that expressly exhibits two-tier board system and German corporate governance system was extensively structured with the strong emphasize of the supervisory board which is highly seen as a key determinant for good and effective corporate governance system in addition to strong role of the management board. Moreover, management of the firm responsible for reporting periodically to the supervisory board despite non-existent of the formal right to direct for specific assignment of a task to management. On the other hand, members of the management remuneration is appointed and dismissed by the supervisory board. In this respect, management board should take into account consideration of supervisory board in the decision-making process. Furthermore, the supervisory board has initiative to determine that to what extent stakeholder groups can be active and have power (H.Schmidt, 2003:8-9).

#### 2.4.1.3. Board Structure and Ownership Control in Germany

It should be noted that the AG consists of three main components which are known crucial integral parts of the German corporate governance system. They are generally called as three governing bodies as the Annual General Meeting (AGM) of shareholders *(Hauptversammlung)*, a supervisory board *(Aufsichtsrat),* and a managing board *(Vorstand)*. In the AGM, there is a possibility for shareholders to use simple majority concept rather than using other voting rules although that expressly specified in law. The Stock Corporation Act *(Aktiengesetz)* proffers to have at least three, and at most 21 members including work representatives. Also, the supervisory board has right to elect managing board but they don’t have power on managing board. Notwithstanding, it is fair to say that a subsidiary’s supervisory board mostly comprises members of the parent company’s managing board in Germany to a large extent (Gugler, 2001:99). Considering managerial remuneration and

disclosure requirements in Germany the Stock Corporation Act *(Aktiengesetz)*, managerial remuneration issue illustrates complex situation. Thus, individual compensation cannot be disclosed while the aggregate compensation of board members and management are published in the annual report.

Specific characteristic of German corporate governance highly concentrated on share ownership. Three groups of stakeholders play extremely significant role in the achievement of corporate governance system in Germany, respectively shareholders, block-holders and financial institutions. Shareholders broadly encompass both block-holders and dispersed shareholders which should be separated from each other. However, it is widely accepted that all large German corporations generally include major shareholders that consist of companies, wealthy families, banks and insurance companies. Taking into account second stakeholder group which is represented by block-holders generates from wealthy families who are also known as a founder of their companies. Financial institutions constitutes third important stakeholder part with which participations create presence of effectiveness in providing effectiveness to corporations. In this group, one can state those big commercial banks, and a number of insurance companies which they have a major role to be performed in fulfilment of their respective objectives (H.Schmidt, 2003:9-10).

Since mandatory co-determination constitutes provision of all large German corporations that mandated labour representation and involvement on the boards of large corporations is seen cornerstone of German corporate governance relying upon banks as lenders. In other words, banks and insurance companies play highly significant role in controlling and managing listed firms among different groups of stakeholders (Gugler, 2001:103). Given the proxy voting right in German corporate governance system, the German Corporate Law clearly expresses how to use proxy voting rights at the AGM. As indicated in German Corporate Law, all shareholders can use their proxy vote right. In assessment of high concentration of ownership in Germany, block-holders and banks can clearly control over management in compared to the role of small shareholder groups. Consequently, in its essence, German corporate governance system clearly differs from Anglo-Saxon countries with its characteristics since it considers relatively high integration between banks as a major credit providers or lenders which play significant role in the corporate governance system.

### 2.4.2. France

The main purpose of this section is to primarily examine basic characteristics of the French corporate governance landscape by providing in depth analysis of the evolution process of French governance structure. Moreover, French governance system will be dealt with from a multiperspective point of view with its considerable dimensions.

#### 2.4.2.1. The Corporate Governance System in France

The conceptual and legal framework of the French corporate governance system depends extremely on European directives as in most of EU Member States deriving from European Parliament to be transposed into national law of the Member states to a certain extent (Charreaux & Wirtz, 2007:1-2). In addition to abovementioned statements, considering French national corporate law and regulation it mainly relies on two distinct corporate governance systems for corporate companies *(Sociétés Anonymes)* that emanates from the 1966 French Business Law. First is known as one-board system depending highly on a Board of Directors *(Conseil d'Administration)* that elected by the General Meeting of Shareholders. In addition, The Board of Directors has right to assign a Chairman *(Président Directeur Général)* of the firm who is responsible for management of the firm. Second system is two-board model depending on Supervisory Board *(Conseil de Surveillance)* of which members consist of shareholders and Management Board *(Directoire)*. In this respect, the members of the supervisory board appointed at the Shareholders General Meeting and supervisory board can appoint the members of management board (Gugler, 2001:125).

**Table 2.2: Key Characteristics Influencing French Corporate Governance**

| Feature | Key Characteristics |
|---|---|
| **Main business form** | Public or private companies limited by shares |
| **Predominant ownership structure** | State, institutional investors, individuals |
| **Legal system** | Civil law |
| **Board Structure** | Unitary (But other structure possible) |
| **Important Aspect** | Many shares have multiple voting rights |

**Source:** A.Mallin, Christine, 2010, Corporate Governance, Oxford University Press, p.226

On the other hand, the legal context of French corporate governance depends heavily on three fundamental laws which deserve remarkable attention that were developed during 2001-2005: 1) the law on new economic regulations of 2001 *(loi sur les nouvelles regulations*

*économiques)*; 2) the law on financial security of 2003 *(loi de sécurité financiéré)*; and 3) the law on trust and modernization of the economy of 2005 *(loi pour la confiance et la modernisation de l'économie)*. The first law focuses on developing guidelines at national level relative to sustainable growth that highly linked to financial system, competition and the corporation. The second law was enhanced in response to the challenges and crisis that occurred after various corporate collapses in financial markets. Last law was designed to entrench necessary regulations in securing information directors' remuneration (Charreaux & Wirtz, 2007:2-3).

**2.4.2.2. Ownership Concentration**

Taking into account ownership concentration in France, which is seen extremely high both in listed and non-listed companies, exhibits a number of differences as well as commonalities in comparison with several European countries. When looking at the non-listed companies' capital, it is worth to mention that individuals or families constitutes main category of owners since they have virtually half of the capital while non-financial firms and holdings occupy place as second important category of owners (Gugler, 2003:124). Table 2.2 clearly indicates the ownership structure in France by 1998-2004. It also highlights significant increases of shareholdings belonging to institutional investors and non-residents.

**Table 2.3: The Ownership Structure of French Listed Companies**

| Year | 1998 | 2004 |
|---|---|---|
| **Private Households** | 10.9% | 8.9% |
| **Non-Financial Companies** | 16.6% | 19.4% |
| **French Institutional Investors** | 26.3% | 29.4% |
| **Non-Residents** | 36% | 37.9% |
| **Others (the State included)** | 10.2% | 4.6% |

**Source:** Banque de France. Cited in: Charreaux, Gérard, Peter Wirtz, February 2007, Corporate Governance in France, Working Paper, and France, available at: http://leg.u-bourgogne.fr/wp/1070201.pdf, p.6

Notwithstanding, according to given parameters and figures in Table above one can comment that share holdings by non-resident is dramatically increasing whilst shareholdings directly controlled by household are declining. It is fair to say that strong decline of cross

shareholdings remain in existence in a particular fierce manner. Consequently, outstanding spread of shareholdings by non-residents means that concentration of foreign ownership is relatively high in France.

#### 2.4.2.3. The Board of Directors and Manager's Compensation in France

Among listed companies belonging to the CAC 40, 75 per cent have a one-board system while 25 per cent have a two-board structure. The Viénot 1 report was designed in 1995 that mainly focused on considering board of directors of publicly listed companies. It also called for revealing its assignments in a broader context to simplify its certain duties. However, the Viénot 2 report was developed in 1999 to take further steps and to call reforms for enhancing the role of the independent directors. It also provided strong and precise statement on the concept of director independence including information on management remuneration (Charreaux & Wirtz, 2007:3-4). In this context, the Viénot 2 report relating to Corporate Governance in France finds two-board system over-priced and inessential. Thus, main purpose of this report is to provide necessity change of French law to enable listed firms having a one-board system. In this way, the possibility to split functions belonging to CEO and Chairman becomes more visible as well as sufficiently clear (Gugler, 2001:125). In this sense, board system structure that adopted by Major French Listed Companies is shown Table below:

**Table 2.4: Examples of the Board System Adopted by Major French Listed Companies (as of 05/31/2006)**

| Name | Market Capitalization (Billion €) | Board System |
|---|---|---|
| **Total** | 125,1 | Unitary: CEO+Chairman |
| **Sanofi-Aventis** | 99,5 | Unitary: CEO+Chairman |
| **EDF** | 77,6 | Unitary: no separation |
| **BNP Paribas** | 67,3 | Unitary: CEO+Chairman |
| **Société Générale** | 52,1 | Unitary: no separation |
| **Axa** | 50,8 | Two-tier board |
| **France Télékom** | 45,4 | Unitary: CEO+Chairman |
| **L'Oréal** | 44,7 | Unitary: CEO+Chairman |
| **Crédit Agricole** | 43,6 | Unitary: CEO+Chairman |
| **Suez** | 38,1 | Unitary: no separation |
| **LV MH** | 37,6 | Unitary: no separation |
| **Viviendi** | 32,3 | Two-tier board |
| **Carrefour** | 31,9 | Two-tier board |
| **Gaz de France** | 26,9 | Unitary: no separation |
| **Renault** | 25,6 | Unitary: CEO+Chairman |

**Source:** Charreaux, Gérard, Peter Wirtz, February 2007, Corporate Governance in France, Working Paper, France, available at: http://leg.u-bourgogne.fr/wp/1070201.pdf, p.8

On the other hand, when compared to other European countries, France appears to be best paid country with regard to managers' compensation of the CAC 40 CEOs. The executive compensation in France depends on the criteria used for the CEOs' pay determination by using peer remuneration levels, the position's responsibilities, and firm performance that gets benefits from accounting measures and stock market institutions (Charreaux & Wirtz, 2007:9). Notwithstanding, the Viénot 2 report broadly considers information on management remuneration as well as precise statement on the concept of director independence. Additionally, the Bouton report deals with enhancements regarding the board of directors and the board committees, in particular audit remuneration (Charreaux & Wirtz, 2007:4).

### 2.4.3. Italy

This chapter broadly covers Italian corporate governance system that exhibits distinctive characteristics as compared to other European countries. Besides, corporate governance structure of Italy will be analysed including legal and national context where Parmalat collapse occurred which is also called Europe's Enron scandal.

#### 2.4.3.1. Key Characteristics of Italian Corporate Governance

It is no doubt that the fundamental feature of Italian corporate governance system was extremely characterized and shaped by Parmalat case which seen highly important lessons for Europe and deserves remarkable attention to be paid. Considering reasons why this corporate collapse occurred one should take into account two main aspects: lack of independence of boards and lack of timely disclosure of information and members of the family take a dominant role across board structure have led to raise Parmalat scandal in Italy. Thus, Parmalat case has been rather influential in the determination of certain standards and core principles in terms of corporate governance. Corporate governance structure of the Italy exhibits a number of differences as compared to the other European Countries. As opposed to the Continental systems, the role of the banks and financial companies seems to be rather limited with regard to ownership structure (Gugler, 2001:130). Notwithstanding, institutional investors remain very little in implementation of corporate governance in Italy.

Considering direct ownership for both listed and non-listed companies is characterized by a high level of families, coalitions, State and other companies. In 1998, a number of regulations and legislative measures regarding corporate governance issue were introduced by Mario Draghi that has been entitled Draghi Law. The main purposes of the Draghi Law are to improve transparency of listed companies which is linked to decision-making process and to enhance minority shareholders' position of Italian companies. Traditionally, Italy has a unitary board system. However, even so, the absolute necessity of the existence of a board of auditors seems to be most essential since the Draghi Law entails this high level of establishment that must be consist of at least three individuals. As for to the main roles of the board of auditors which is to control the organizational structure of the company's that encompass internal control system, accounting and administrative system (Christine, 2010:230).

**Table 2.5: Key Characteristics Influencing Italian Corporate Governance**

| Feature | Key Characteristic |
|---|---|
| **Main business form** | Limited liability companies, partnerships |
| **Predominant ownership structure** | Non-financial/holding companies, families |
| **Legal system** | Civil law |
| **Board structure** | Unitary |
| **Important aspect** | Board of auditors required |

**Source:** A.Mallin, Christine, 2010, Corporate Governance, Oxford University Press, p.230

In addition to the Draghi Law, in 1998, Borsa Italiana published Preda Report encompassing a number of recommendations related the field of corporate governance. The recommendations introduced in this report focused on developing composition of the board, the formation of key board committees, the roles of chairman and CEO, and the independence of directors. However, it should be noted that the legal basis of this code does not impose necessity. Companies in Italy are free to adopt the codes since these codes grounded on "comply or explain" basis. On the other hand, in addition to the first Preda Report was published in 1998, another report was introduced in 2002 which is called as Preda Report 2. Apart from first Report, Preda Report 2 deals with various ranges of fields, inter alia, such as appointment and remuneration of the directors, internal control and relations with institutional investors including other shareholders (Christine, 2010:231).

#### 2.4.3.2. The Board Structure

As has been broadly expressed in the previous chapter, the Preda code notably focused on developing a number of recommendations in order to introduce the role of the board of directors, remuneration committee, supervision to the general performance of the company and reporting for the shareholders. The focal point of the Preda code is to enhance shareholder value to provide an articulation with Italian law by taking into account internationally recognized requirements. In other words, main purpose is that shareholders' interests should be secured by the directors. Taking into consideration composition of the board of the directors, the board is generated both from executive directors and non-executive directors (Christine, 2010:231).

However, the main role of the chairman is to call and chair the meetings. The executive committee and managing directors' responsibility is to periodically report to the board of directors. Besides, the report clearly indicates the significance of shareholder meetings (Christine, 2010:232).

Furthermore, it is evidently stated that directors should attend meetings by providing broad participation where they can provide information to the shareholders. As to the members of the board of auditors issue in Italy, the main role is to represent shareholders to secure their interest. In that respect, they can act independently in accordance with its autonomous status (Christine, 2010:234).

#### 2.4.3.3. Ownership Structure and Managerial Compensation

It is quite common that family-owned ownership structure is prevalent in general use in Italy and separation of ownership is limited. In other words, ownership control is strongly shaped by a high level of concentration through pyramidal structure as in most other European countries. Formerly, the State was an important agent in Italian corporate governance. However, according to given data belonging to 1996, the state represented 30 per-cent of the Italian stock market. Due to privatization the share of the state decreased 19 per-cent (Gugler, 2001:130). As has been clearly stressed in the Preda Report that the board of directors may determine the remuneration committee and remuneration committee makes recommendation to the board of directors regarding remuneration matter. It is also strongly emphasized in Preda code that the companies can be flexible in determination of remuneration issue (Christine, 2010:233).

### 2.4.4. United Kingdom

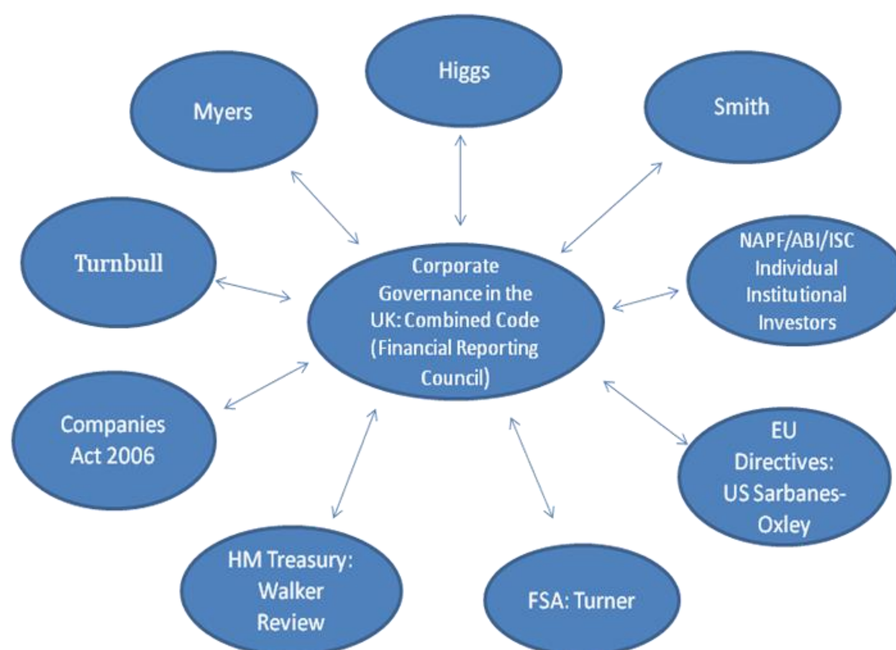
This section aims at dealing with the corporate governance structure of the UK that clearly differs from Continental European countries with its fundamental features and basic characteristics. As in most countries the corporate governance system of the UK was also affected corporate scandals and financial crisis which led to make recommendations in response to the raising challenges deriving from bad executed corporate governance practices.

#### 2.4.4.1. Key Mechanism of UK Corporate Governance System

The legal framework and basis applying to corporate governance structure of the UK is characterised by Combined Code (1998) that gave rise to composition of three significant codes: the *Cadbury* Report (1992), the *Greenbury* Report (1995), and the *Hampel* Report (1998). This trilogy constitutes legal context of EU corporate governance framework. However, *Cadbury* Report clearly differs from remaining two Reports since it has highly influential and considerable effects in the creation of internationally recognized codes. The legal context of the Combined Code of which recommendations embodied *Cadbury, Greenbury* and *Hampel* reports, is grounded on “comply or explain” basis. Considering main purpose of other Combine code is to review and clarify internal controls of the business. After several corporate failures occurred in the UK that engendered lack of investor confidence in the financial reporting of UK companies made necessary to take further steps in the achievement of good corporate governance practices. Therefore, the Financial Reporting Council, the London Stock Exchange, and the accountancy profession initiated to constitute a Committee on the Financial Aspects of Corporate Governance in May 1991 (Christine, 2010:27).

After the Committee established which was chaired by Sir Adrian *Cadbury* therefore it is called as *Cadbury* Report, the Committee developed the well known report in December 1992. The *Cadbury* Report formed a Code of Best Practice through which the boards of all listed companies manage through “comply or explain” basis which means that companies should comply with the code or they should explain that to what extent they did or did not complied. However, *Greenbury* Report was developed in 1995 to constitute recommendation relating to disclosure of the directors’ remuneration issue. In addition to the *Cadbury* and *Greenbury* reports, the *Hampel* report was developed to revise by taking into account *Cadbury* and *Greenbury* recommendations (Christine, 2010:28).

**Figure 2.1: Development of Corporate Covernance in the UK**




**Source:** A.Mallin, Christine, 2010, Corporate Governance, Oxford University Press, p.27

In the light of above, it is worth noting that the *Cadbury, Greenbury* and the *Hampel* reports seems to have commonly concentrated on bringing down the managerial power by exerting recommendations and setting corporate governance codes, in particular by using “comply or explain” mechanism.

### 2.4.4.2. Companies Act 2006

In the light of developments which provide implementation of good corporate governance practices, the *Cadbury, Greenbury* and the *Hampel* reports constituted the integral parts of the UK corporate governance framework. Considering developments affecting UK corporate governance system significant changes became extremely necessary in UK company law. In this sense, to set context of UK corporate law the Modern Company Law Review has been published in 2002 which encompasses the strong integrity of the judiciary and the legal system with regard to corporate governance. Given proposals outlined in the Modern Company Law Review it mainly comprises: statutory codification of directors’ common law duties, improve audit requirements and company reporting, disclosure of information regarding the annual report and accounts and disclosure of voting. On the other hand, the Company Law Reform Bill has been formed in November 2005, and the Companies Act was regulated in 2006 to review for updating former Companies Act’ legislation.

However, it brings some noteworthy changes which would be effective on directors, shareholders, and auditors. Overall, the Company Law Review proposals bring following outstanding features (Christine, 2010:33):

- It provides use of electronic communications for communicating with shareholders;
- It provides more timely information to shareholders;
- It makes easier proxy voting right to the shareholders;
- It makes necessary to codify directors' remuneration;
- Shareholders will be able to agree limitations on director's liability.

Taking into consideration the focal point and the context of proposals it seems to be very apparent that shareholder rights have been improved in various ways by providing proxy voting rights, more timely information to the shareholders, and use of electronic communications.

#### 2.4.4.3. Financial Reporting Council

Similar to the *Cadbury, Greenbury* and the *Hampel* reports and Companies Act, Financial Reporting Council (FRC) focused on developing corporate governance standards by working effectively with the help of its six main operating bodies. In addition, the FRC formed a new committee to move forward its work on corporate governance. Moreover, the main purposes of the FRC have flowing aspects (Christine, 2010:34-35):

- To provide continuity of Combined Code on corporate governance and its application;
- To ensure that related guidance , such as that on internal control, is current and relevant;
- Influencing EU and global corporate governance developments;
- Helping to promote boardroom professionalism and diversity;
- Encouraging constructive interaction between company boards and institutional shareholders.

In attempt to assess abovementioned aspects, FRC mainly aims at dealing with necessary developments that provide promotion of current corporate governance regulations

in the UK. It also highlights that the absolute necessity of existence of the Combined Code which is highly seen as a cornerstone for corporate governance structure of companies in UK.

#### 2.4.4.4. Ownership Structure

When compared to corporate governance structure of the UK fundamental characteristics clearly exhibit a number of commonalities with US' basic features with regard to corporate governance implementations in contrast to most European Countries. In other words, regarding ownership structure and corporate governance practices, UK evidently indicates distinctive features with Continental European countries to a considerable extent. Table 2.6 below indicates the ownership concentration percentages by countries including US within a comparative context.

**Table 2.6: Ownership Concentration**

| | Widely Held* | Family Control | Pyramid Control | Median Largest Voting Block | Family Wealth |
|---|---|---|---|---|---|
| **France** | 60% | 20% | 15% | 20% | 29% |
| **Germany** | 50% | 10% | 20% | 57% | 21% |
| **Italy** | 20% | 15% | 20% | 55% | 20% |
| **United Kingdom** | 100% | 0% | 0% | 10% | 6% |
| **United States** | 80% | 20% | 0% | 5% (NYSE) 9%(NASDAQ) | N.A. |

* *"Widely held" is the fraction of firms with no controlling shareholder among the 20 largest companies by stock market capitalization at the end of 1995. A company has a controlling shareholder if the some of a shareholder's direct and indirect voting rights exceeds 20 percent. Family control is the fraction of the 20 largest companies, where the controlling shareholder exercises control through at least one publicly traded company. "Median largest block" is the median size of the largest ultimate voting block for listed industrial companies. "Family wealth" is the percentage of total stock market capitalization controlled by the ten richest families.*

**Source:** Enriques and Dolphin (2007). Cited in: Odenius, Jürgen, 2008, Germany's Corporate Governance Reforms: Has the System Become Flexible Enough?, International Monetary Fund Woking Paper, available at: http://www.imf.org/external/pubs/ft/wp/2008/wp08179.pdf, p.4

From this point of view, the UK has a widespread ownership feature held by a large number of listed companies (Gugler, 2001:196-197). In its essence, the UK corporate landscape has convergence areas with the US corporate governance features. On the other hand, since shareholders in the UK have extensive rights leading not only to strong institutional investors but also more active takeover market (Gönençer, 2008:19). Therefore,

institutional investors are dominant in the UK those who actively participate in corporate governance for exercising their voting right (Gönençer, 2008:69).

### 2.5. Summary

This chapter has examined how corporate governance is applied and the ways companies operates the corporate governance process in some selected EU countries respectively Germany, France, Italy, and UK. It is notable that the legal framework applying to the EU countries are subordinated and adopted mainly by the European Directives to be implemented by all Member States that derives from the EC which is known the most important key actor in implementation of EU corporate governance regulations at EU supranational level. Considering convergence or divergence debate, even though most EU countries share common features and certain characteristics of corporate governance structures and processes that embedded itself as a central element of a country's legal context there are a number of divergence areas as well as convergence fields. Particularly, UK shares common features and characteristics of corporate governance with US in contrast to European countries, in particular regarding ownership structure, board system and legal system.

In the achievement of good corporate governance practices within the EU, it is extremely significant that awareness of the EU corporate governance directives, regulations, best practices, and guidelines for European countries to better comply with EU corporate governance standards alongside with internationally recognized standards. As in most countries, the development of corporate governance practices within Europe driven by corporate collapses and financial crisis that emanates from weak enforcement law, misuse of corporate assets by directors, lack of effective control and managerial fraud. In this sense, in order to reassure stakeholder confidence and to restore investor confidence again in financial markets remarkable attention has been given to *Lamfalussy* Report, *Winter* Report and Lisbon Agenda by EU. These outstanding steps taken by the EU to be transposed into national corporate governance law became integral part of the EU best practices of corporate governance since they made European countries more conversant with EU corporate governance requirements and recommendations in terms of corporate governance.

To have a better understanding mechanism and characteristics of corporate governance in selected EU countries it is fair to say that corporate governance structure based on individual codes as well as EU Directives and Regulations depending significantly on

transparency, disclosure, accountability, and independent of the directors. From this point of view, to facilitate better access to current international best practices, the EU aimed to achieve this mission with the adoption of its Action Plan for Modernizing European Company Law and Enhancing Corporate governance in the EU. Besides, *Lamfalussy* Report, *Winter* Report, and Lisbon Agenda focus on developing certain regulations and requirements and deals with how to improve European corporate governance practices. Thus, it seems to have provided broad consensus on certain areas among EU countries although it is widely accepted "one size does not fit all" concept which means there is no identical corporate governance model that is applicable to all countries. However, even so, EU recommendations play significant role to encourage further convergence among Member States on key areas on the basis of corporate governance.

Given parameters and features mentioned in last chapter for Germany, France, Italy, and UK with regard to corporate governance practices, it is clear to say that while Germany, France and Italy adopted civil law, the legal system of UK based extensively on common law. France and Italy have a unitary board structure whilst UK has a one tier board system. By contrast, the Germany comprises a dual board structure and co-determination which entails labour representation in the corporate governance system. Considering ownership structure for countries mentioned (in Table 2.6), in France where individuals or families constitutes main category of owners, pyramidal structure is one of the dominant feature in comparison with Germany, Italy and UK.

Further assessment of the position of EU corporate governance, in France in terms of corporate governance structure, Viénot Reports (1 and 2) and Bouton Report provide a number of reforms relating to corporate governance practices to be transposed into French national law. In Italy family owned ownership structure is also prevalent as in most of the European countries. As opposed to the UK, pyramidal structure is predominantly considered and separation between and ownership is limited. Preda Codes (1 and 2) and Dragi Law brings several important requirements and recommendations to the Italian corporate governance law in connection with corporate governance issues. However, in the UK, corporate governance structure was shaped mainly by Combined Code (1998) that formed a trilogy of codes that are well known as the *Cadbury (1992), Greenbury (1995),* and the *Hampel (1998)* reports.

# 3. CORPORATE GOVERNANCE PRACTICES IN TURKEY

## 3.1. Analysis of Turkish Economical and Financial Environment from Historical Perspective

Before getting into details relating to corporate governance system of Turkey, to have a better understanding business structure and corporate culture in Turkey, it would be beneficial to give an overview and in depth analysis concerning economic policies and financial environment and capital market of the country from historical perspective. Since the establishment of the Turkish Republic in 1923 until 1980s, the Turkish economy was predominantly based on state-oriented. Thus, State-owned enterprises *(SOEs)* were established in 1930s. The main purpose of the *SOEs* is to foster trade and economy of the government since private sector was grounded extremely on unstable economical structure while the Turkish economy significantly relied on state-oriented. In this structure state takes precedence in determination of industrial companies by playing significant role among owner and manager. Notwithstanding, due to existence of dominant power of *SOEs* created absence of the private sector effectiveness into the market since the state intervention became more apparent that leads to low competitive market environment and ineffective investment. However, at the beginning of the 1960s there was a significant increase of public sector efficiency.

Beginning of the 1980s, the government has taken further steps in the policy of export to provide strong articulation of a liberal market economy. Accordingly, phenomenon of privatization has occupied significant space of the government's agenda. In parallel to the developments of liberalization in the economy, Capital Markets Board of Turkey (CMB) and Istanbul Stock Exchange (ISE) were established. Most importantly, the Capital Market Law (CML) was enacted in 1981. Taking into consideration economical indicators, economic policies and financial environment of Turkey there were high deficits in the economy of the government that led to high inflation rates between 1980s and 1990s. This level of inflation rates created presence of instability of the macro-economical indicators and has led to fluctuations. On the other hand, high interest rates and low economic growth arising from high inflation rates led to increase of financial risks (Gönençer, 2008:95).

Taking into account all these drawbacks mentioned above relating to indicators of the Turkish economy, Turkey has been the country which is often described the country as land

of uncertainties due to instable economic atmosphere. In the light of above features, the period of 1987 and 1997 is the well known period as a cornerstone for large shareholders that had their ownership within business groups in Turkey. It is widely known that the most considerable economic development has been shown in trade liberalisation and the Gross Domestic Product (GDP) reached 40% that derives from increasing exports. Similarly, the Customs Union with the EU moved country forward and made considerable contribution and economic development to the Turkey that has started to enact in 1996. However, the crisis of 2000/2001 caused major macroeconomic instability and chronic inflation. As a result of this big deepest crisis, Turkish Baking system has suffered and got into trouble because of the 2000/2001 crisis (OECD, 2002:8). Considering Turkish candidacy status towards an EU full membership that created positive financial environment enabled to Turkey to increase foreign investments and capital. Moreover, after becoming a candidate for EU membership in 1999, Turkey adopted to regulatory reforms to fulfil its legislation within the context of EU accession process.

**Table 3.1: Comparison of Equity Market Indicators between ISE and EU Average**

| | **Turkey** | **EU Average** |
|---|---|---|
| **Market Cap. (in million Euro)** | 137,531 | 480,026 |
| **Total number of listed companies** | 305 | 472 |
| **Total value of share trading (in million Euro)** | 237,706 | 1,108,996 |
| **Turnover ratio (Total value of share trading /market cap.)** | %173 | %231 |

**Source:** ISE and FESE. Cited in: Gönençer, Elif, 2008, “Development of Corporate Governance in the European Union and in Turkey as a Candidate Country; An Assessment of Theoretical, Legal and Practical Aspects”, Master Thesis in Advance European and International Studies, Paris, p.96

As has been shown in the Table above, new structural regulations gave rise to increase number of foreign investors entering the Turkish markets. Notwithstanding, successful

development process of the good corporate governance was also affected by the 2000/2001 financial crisis in Turkey partly that led to adopt integration with international capital markets through regulatory reforms to increase foreign investment efficiency. After the 2000/2001 financial crisis the country took further steps to remove drawbacks and negative consequences of the crisis by initiating a number of reforms. Particularly, with the guidelines of the IMF the banking system has been revised within the context of recovery plan. Consequently, while the GDP per capita in Turkey dramatically increasing the inflation rate has decreased from 70-50 in 1990s to the 10 percent and annual growth rate has reached 7-7.5 percent in 2002-2006. Today Turkish economy takes place among top 20 biggest economies across the world (Gönençer, 2008:95).

### 3.2. Legal, Regulatory and Institutional Framework and Institutional Bodies of Turkish Corporate Governance

It is important to take note that Corporate Governance Principles (CGP) of Turkey was issued by the CMB which is a key player and also integral part of corporate governance in Turkey in addition to the Turkish Commercial Code (TCC) and CML. These CGP has been developed by taking into account OECD Principles of corporate governance as well as internationally recognized standards by the CMB in 2003 which can be used primarily by listed companies and joint stock companies. The legal basis of CGP of Turkey were grounded on a “comply or explain” basis as in most European countries and the Principles are applied voluntarily providing that the listed companies should disclose whether they comply with the code or not, if not they should explain reasons why they have not complied (Gönençer, 2008:99). The principles adopted comprise and strongly addresses the use of “one share-one vote” principle. On the other hand, in the light of strong integration with the international markets and increasing significant foreign investors entering to the Turkish markets Turkish Industrialists’ and Businessmen’s Association (TUSIAD) took initiative by setting the Corporate Governance Code of Best Practice: Composition and functioning of the Board of Directors. Most importantly, as indicated in Banking Law in Turkey, the Banking Regulation and Supervision Agency (BRSA) plays key role in determination of corporate governance structures, processes and principles to be applied by Banks in Turkey.

Taking into corporate governance implementations of Turkey account, the 2000/2001 financial crisis seems to be very important turning point of the Turkish governance that made necessary to regulate related rules and triggered to make recommendations by adopting

structural reforms and the democratic principles of accountability and transparency with respect to corporate governance practices. Also it provided the most impressive development to the country by making Turkey more conversant with EU corporate governance requirements and recommendations as well as internationally recognized standards as a candidate country to the EU. The another major step is to be considered that strong articulation of Turkish economy with the international capital markets and to better comply with EU Capital Markets has been achieved not only to improve trade with EU partners but also attract EU investors. On the other hand, in addition to the above mentioned institutional and legal bodies dealing with corporate governance issue, the Corporate Governance Association of Turkey is the another important key player in developing and applying best corporate governance practices. It contributes by publishing books, articles and newsletters related recent corporate governance developments as well as providing education and training programs for the board of directors.

### 3.3. Corporate Governance Principles of Turkey

As has been highlighted in the previous chapter that in 2003 the CMB has defined Corporate Governance Principles of Turkey and updated in 2005 and the legal basis of CGP of Turkey were grounded on a “comply or explain” basis. “Comply or explain” mechanism means that the listed companies should disclose a Corporate Governance Compliance Statement whether they comply with the code or not, if not they should explain reasons why they have not complied. It should be noted that the CMB benefited from the OECD corporate governance principles that can be applied voluntarily. Furthermore, the principles split into four main areas: Shareholders, Disclosure and Transparency, Stakeholders and Board of Directors.

First chapter considers the Principles on shareholders’ rights and their equal treatment that encompasses issues such as shareholders right to obtain information, right to vote, right to participate in the general shareholders’ meeting, obtain dividend and minority rights. The second chapter discusses the Principles relating to disclosure and transparency. Disclosure and transparency part contains Principles that addresses necessary establishment of information policies in companies in connection with shareholders that includes information accessibility. The third chapter analyses stakeholder issue that broadly encompasses regulation between company and various interests’ groups such as employee, customers, and suppliers that are subject of stakeholders. Last chapter addresses the Principles concerning

Board of Directors which significantly relies on functions, duties, responsibilities, obligations, composition, remuneration and structure of the board of the directors.

### 3.4. Turkish Corporate Governance Framework at a Glance

The basis corporate governance framework of Turkey has developed through structural reforms that have been realized in accordance with IMF receipt for recovery in past decade. Also, it is widely known that the CMB is a key player in determination of legal and institutional framework for corporate governance in Turkey by issuing CGP of Turkey. Besides, the establishment of the CML is also constitutes integral part of the corporate governance legal framework. The legal system of Turkish corporate governance based on "civil law" which is most prevalent in Continental Europe as compared to the "common law" mostly applied in Anglo-American countries. Within this scope, Turkish civil law that constitutes backbone of the corporate governance framework alongside TCC shares convergence areas with French law.

Moreover, the characteristic of the corporate governance structure in Turkey is predominantly based on Family owned companies who organize a large number of companies by using pyramidal structure. Therefore, the corporate governance system in Turkey is often described as the "insider system" the insiders composed of country' richest families (Yurtoğlu, 2003:16). Furthermore, Turkish corporate governance culture originates from concentrated ownership, to a large extent, often in the form of family-controlled, financial industrial company groups where Capital Markets Board monitors corporate governance practices with its regulations and principles. Also, the structure of Turkish companies and firms depend heavily on highly concentrated ownership and insider-dominated board. However, more recently, Turkish companies to do business abroad and compete for foreign capital through structural reforms encouraged to adopt relevant corporate governance regulations regarding corporate governance practices (OECD, 2006:11).

As has been explained in the first chapter of this study, in addition to the well-known Enron collapse the occurrence of Parmalat scandal in Continental Europe triggered to take a number of necessary measures in solving challenges. In this sense, relevant corporate governance requirements and regulations have been the focal point of EU agenda in achieving certain priorities with regard to corporate governance. In parallel to these developments, the EU has achieved its main mission by addressing Transparency Directive *(2004/109/EC)* and

Directive on the exercise of Shareholder rights *(2007/36/EC)* in the light of legislative improvements. In the light of above arguments, next chapter extensively reviews Turkey's legislative regulatory frameworks by taking into consideration EU approach to corporate governance including recent developments during the EU harmonization process to the Turkey. Most importantly, to facilitate access to current EU best practices next chapter will examine that to what extent there exist convergence areas between the standards of corporate governance of Turkey compared to the theoretically derived standards of good corporate governance. In parallel to the above statements next chapter deals with key characteristics of Turkish corporate governance landscape by using descriptive analysis on corporate governance elements through which system works to reach particular outcome. In this scope, driving forces of Turkish corporate governance will be dealt with respectively shareholder rights, ownership structure and control, the board of directors, disclosure and transparency, audit and stakeholder issues.

### 3.4.1. Shareholder Rights

Considering features it can be stated that since the Turkish economy was based on predominantly state-oriented, in particular between 1923 and 1980s, and private sector was grounded extremely on instable economical structure. In that sense, state takes precedence in determination of industrial companies by playing significant role among owner and manager. Therefore the state becomes more effective to set market mechanisms. However, the shareholders' activism in capital market remains rather limited than expected. Also, shareholder participation to general shareholder meeting in Turkey is relatively low. Besides, shareholders do not exert their right to request information. Due to fact that distinctive cultural attitudes and existence of low NGO culture shareholder activism remains very little in Turkey (Gönençer, 2008:105). In other words, lack of NGOs culture creates absence of shareholder activism and leads to lack of shareholder culture in Turkey to a large extent.

Taking into consideration reports that addresses some companies prefer to exert complex proxy voting procedures for minority shareholder which leads to difficulty for minority shareholders to exercise their voting rights. However, the CMB has taken steps to remove restrictions in exercising proxy voting by issuing new procedures. Moreover, cumulative voting is applied voluntarily in Turkey. The CMB Principles regarding cumulative voting clearly expresses that procedures concerning cumulative voting should take place in the company's articles (Corporate Governance in Turkey, 2005:11). Considering a Minority

Shareholders Meeting Index (MSP Index) rating that has been shown in the Table 3.2 below stresses comparison of corporate governance system highlighting that there is a strong relation between MSP Index and ownership concentration. For instance, in case of high level of MSP then ownership diffusion becomes high as well as more investment entering a country's capital market due to high level of MPS.

**Table 3.2.: Minority Shareholder Protection Index**

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

| | | | | | |
|---|---|---|---|---|---|
| **Italy** | 69 | 7 | 20 | 0 | 24 |
| **Turkey** | 51 | 0 | 40 | 0 | 23 |
| **Indonesia** | 45 | 0 | 40 | 0 | 21 |
| **China** | 25 | 0 | 20 | 0 | 11 |

**Source:** Gourevitsch and Shinn, 2005

As has been indicated in the MSP Index Table above, Turkey has a low MSP percentage (23) after Italy (24) whilst Anglo-American countries have high MSP percentage. The range of Turkey is classified at the bottom of the Table which means that existing less effective management and investor confidence in Turkey where minority shareholder rights is rather weak. In other words, Turkey ranks a country with a high ownership concentration as compared to concentration of shareholding percentages by countries. In a nutshell, overall there is no shareholder culture in Turkey and minority shareholder protection is rather poor compared to the above mentioned features with the current EU corporate governance standards and practices.

Attendance to the annual general meetings in Turkey for shareholders can be made in two ways: through personally or proxy voting. Since proxy voting procedure entails some documental arrangement leading to high cost thereby proxy voting cannot be exercised often in Turkey. However, considering proxy voting applying and procedure in the EU new European Directive on Shareholders Rights removes all barriers and restrictions in front of proxy holders by securing appointment of the proxy holders. On the other hand, necessity of electronic-voting and electronic participation for shareholders should be available as indicated in relevant EU Directives. As has been placed in the TCC shareholder rights is applied "one share- one vote "principle. Given the shareholders right to get information from the company and the internal auditors has been regulated in the TCC. By contrast, the TCC does not provide right to ask question to the companies for the shareholders (Gönençer, 2008:107). Considering the EU Directive encompasses the notice and agenda of the general meeting for which relevant information should be provided 21 days before general meetings to vote. If shareholders prefer to vote by electronic means for which this period can be 14 days. However in Turkey, this period has been indicated 15 days. In this sense, in the light of above Directive, the Principles in Turkey does not require obligation. In assessing shareholder voting rights in Turkey as compared to the EU Directives, current TCC and capital market relevant legislation should be changed to comply with the EU Directive. (Gönençer, 2008:108).

### 3.4.2. Ownership Structure and Control

When considered corporate governance phenomenon the relationship between ownership and control takes extremely significant space at the centre of the debate and separation between ownership and control issue is seen highly problematic matter that emanates from conflict of interests among various interests groups and directors. The basic characteristic of the corporate governance structure in Turkey, as in most Continental European Countries, is predominantly based on Family owned companies who organize a large number of companies through pyramidal structure. In this regard, the Turkish corporate governance structure is composed of business groups that generated from industrial and financial companies organized through the legal form of a holding company. These business groups mentioned are controlled by a single family or a coalition of a small number of families (Yurtoğlu, 2003:5). Table 3.3 below clearly indicates the ownership concentration by countries including Turkey.

**Table 3.3: Ownership Concentration by Country**

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

**Source:** Gourevitsch and Shinn, 2005

It is fair to say that Turkish companies show highly concentrated and centralized ownership structures and Families, directly or indirectly, which has almost 80 percent of all companies that hold the majority control. Within this scope, the separation of ownership and control is mainly achieved through pyramidal or complex ownership structures. Also, the controlling owners' benefits from dual-class shares in achievement of separation of ownership and control issue. Therefore, it is widely observed in Turkish companies family ownership takes precedence as a dominant owner at the top of the hierarchy and constitutes considerable control over the company's management through a pyramidal structure (Yurtoğlu, 2003:7-8). Given the abovementioned features and certain characteristics of Turkish corporate governance landscape, due to the high concentration of ownership held by a family block holders (controlling shareholder) not only control the company but also monitor the boards. Thus, a conflict of interest among minority shareholders and large shareholders can be frequently raised deriving from pyramidal ownership structure between management and minority shareholders (Gönençer, 2008:21-22).

When compared Turkish family-owned structure to the other European countries exhibits common features, particularly with Italy. In Italy family-owned control has more than 10 percent of the total market value that pertain to the listed companies. According to reports of the *Faccio* and *Lang* (2002) expressly highlights that families who are the insiders in most of countries having the civil law system, own about 45 percent of more than 5000 publicly listed Western European companies (Faccio and Lang, 2002:2). However, features of separation of ownership and control structure of Turkey clearly distinguish from the EU since the basic characteristic of the corporate governance structure of Turkey is drastically based on Family-owned companies that generates from country's richest families and business groups who organize and control the company through pyramidal structure. In addition, as compared to Turkish family-owned structure to the other European countries shares also common features of the economy within the EU (Gönençer, 2008:104).

### 3.4.3. The Board of Directors

The independence of the board of directors and controlling shareholders from a good corporate governance perspective is seen as a most essential mechanism on company management in Turkey. However, in Turkey most boards cannot manage independently from block-holding shareholders. Considering research conducted, 80 percent of the listed companies had at least one board member who is a member of the controlling family

(Gönençer, 2008:108). Similarly, owner families constitute key determinant of the boards of Turkish companies where boards take significant place at internal mechanism of control that considers the owners' influential role on the company. It should be noted that both in the composition of board and in determination of board size shareholder and manager interests have a strong determinant role (Yurtoğlu, 2003:11). For instance, it can be observed that in 206 companies there is at least one board member who is a member of the controlling family. In addition to that more than one third of all board members consist of large shareholders that lead to low board size on the board of directors (Gugler, 2001:180). As to the board structure of the Turkish corporate governance there is a one-tier board system which appointed by the shareholders as in the case most of EU countries. There is no any requirement in terms of committees and regarding the qualification of the board members that has been specified in the TCC. However, on the contrary, the CMB imposed a provision that entails establishment of an audit committee for listed companies that composed of at a minimum of two non-executive directors. Besides, the CMB Principles includes also requirement concerning the establishment of corporate governance committee of which members should be composed of non-executive directors (Corporate Governance in Turkey, 2005:14).

On the other hand, three significant board committees were specified in the EU Recommendations concerning the role of non-executive and supervisory directors of listed companies as nomination, compensation and audit committees with a majority whose members should be independent directors. However in Turkey as compared to the EU, there are remuneration and nomination committees as two separate units. Also, there is no an audit committee with a majority of non-executive independent directors (Gönençer, 2008:109-110). It should be highlighted that there is neither any provision in TCC nor in capital market legislation that entails "independent board members" which is most essential as an absolute necessity for the existence of effective and good corporate governance. By contrast, the EC Recommendation clearly expresses that the board should have a sufficient number of independent members. Taking into consideration EC Recommendations notably encompasses the role of the CEO and board chairman that should be transposed into national law to be applied. In spite of the fact that, it has been recommended by the CGP of Turkey its exercise is rather weak in comparison with EC Recommendation (Gönençer, 2008:110).

### 3.4.4. Disclosure and Transparency

It is clearly known that in order to provide disclosure arrangement within the EU Council Directives *78/660/EEC* on the annual accounts of certain types of companies was amended by Directive *2006/46/EC* in 2006 that expose Member States to disclose of an annual corporate governance statement (Directive 2006/46/EC of the European Parliament and of the European Council, 2006). In Turkey regarding disclosure requirements in connection with corporate governance issue the CML and the CMB Communiqués secure for comprehensive disclosure of information by implementing following responsibilities: i) changes in capital structure and control, ii) major purchases, sales, and leasing of fixed assets, iii) major changes in operations and investments, iv) changes in the financial structure, participations, and joint ventures, v) major administrative changes, and vi) details on the acquisition or sale of assets (Corporate Governance in Turkey, 2005:15). Also, the CMB Principles encompass further details relating to disclosure issue. It addresses that information is to be disclosed by companies which listed on an exchange outside Turkey by taking into account the rules of the foreign exchange. In addition, within the context of EU Directives, the CMB has taken further steps to support using of Internet by companies in disclosing information. It has also required companies to use their website for public disclosure including voting results of the general meeting of the companies. Moreover, a Communiqué was issued by the CMB with which stock exchange impose the disclosure of information electronically when necessary (Corporate Governance in Turkey, 2005:15).

In fulfilment of disclosure and transparency mission, which is most essential priority as well as absolute necessity for the existence of effective and good corporate governance, in Turkey the CMB formed by issuing financial reporting standards within the context of International Financing Reporting Standards (IFRS). Therefore, the Turkish Accounting Standards Board (TASB) adopted the original IFRS and translated into Turkish. The IFRS and the International Standards on Accounting (IAS) are two key determinants which were recognized to be applied by the EU. In the light of above, in order to realize transparency standards at EU level regarding accounting and financial reporting, the TASB took significant step by translating IFRS and IAS of EU into Turkish to be implemented by Turkish companies (Gönençer, 2008:111). Considering EU Regulations relating to disclosure of corporate governance compliance statements should take place in the annual reports covering structure and composition of board of directors and independent members, remuneration of

the board members.[3] As indicated in the CGP that members of boards and shareholders who has 5 % or more of equity capital pertaining to company should provide information to the CMB. However, this does not necessary for trade secrets to be disclosed. Mandatory rules in Turkey which required by the TCC that director compensation either be set in the company's articles or, be determined at the annual meeting. In parallel to the EU Recommendations which addresses the necessity of disclosure of individual remuneration. However the CMB Principles goes further in stating the compensation of individual directors to be disclosed in the annual report (Corporate Governance in Turkey, 2005:15).

### 3.4.5. Audit and Stakeholder Issues

It is worth noting that in the achievement of company's priorities such as competitiveness and the creation of wealth would be only possible in close cooperation with the diverse range of group of interests that pertain to the stakeholders which generates from investors, creditors, employees and suppliers. Therefore, major consideration and remarkable attention is given by the OECD as well as governments to stakeholder issue. It is therefore CMB focuses on developing stakeholders' participation in the corporate governance management by developing principles in Turkey (OECD, 2006:3). The most important matter from the EU's point of view is to reduce corruption as well as to consider Corporate Social Responsibility (CSR) issues like consumer and environmental protection which is one of the major consideration with which Turkey has to cope that clearly stands as an obstacle in front of the EU accession process. Since combating corruption is seen most essential priority for the EU accession process for candidate countries as well as Member States, accession countries are required to decrease corruption (Gönençer, 2008:116).

According to a Communiqué issued by the CMB that requires all listed companies to have a semi-annual and annual financial reports audited by an independent audit firm. According to the Communiqué, companies should be audited by external audit that must be an independent and certified by the CMB. Also, it is compulsory for companies that they must change their auditors at least every five years (Corporate Governance in Turkey, 2005:16). Considering audit committee that should be required to control and manage external audit services. Most importantly, in parallel to the EU Regulations companies must have an audit committee under the CMB Communiqué that generates from at least two non-executive

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[3] Corporate Governance Principles Compliance, available at: http://www.spk.gov.tr/displayfile.aspx?action=displayfile&pageid=56&fn=56.pdf.

directors. Given independency of the members that is not considered in the Communiqué in contrast to the EU Regulations (Gönençer, 2008:116).

## CONCLUSION AND RECOMMENDATIONS

We have witnessed that in last decade of the twentieth century term corporate governance has gained major consideration in creation of high capital market value by increasing and maintaining of stakeholder confidence to a considerable extent. Therefore the sound corporate governance deserves very special attention for both developed and developing countries across the world. It can be observed that the development of corporate governance practices within Turkey driven by corporate collapses and financial crisis as in most European countries that derives from weak enforcement law, misuse of corporate assets by directors, lack of effective control and managerial fraud. Within this scope, in order to reassure and restore stakeholder confidence again in financial markets considerable attention has been given to the corporate governance phenomenon in business world.

Thus, the term "good corporate governance" placed at the centre of the literatures pertaining to a number of disciplines such as finance, economics, accounting, law, and management. Also the importance of corporate governance issue presented us to draw a picture from different perspective and to make a theoretical classification between different corporate governance systems used. In parallel to these developments, the necessity of corporate governance code became very important after emerging several financial crisis and corporate collapses in order to provide more transparency, accountability and investor confidence in financial markets. From this point of view, more attention has been directed to regulate necessary requirements by countries to be transposed into national law and political context. Notwithstanding, in order to reach good corporate governance standards it has been seen that the Cadburry Report (1992) and OECD corporate governance principles have been influential in the development of corporate governance codes and principles.

Corporate governance is a system that broadly influences investors, employees, customers, and suppliers to a large extent as well as economic impact on governments' capital market. It works and coexists together with its elements and dimensions by providing consistency between two dominant types of systems that are known "insider-model" and "outsider-model". Broadly speaking, corporate governance models split into two corporate governance models which are called "outsider system" that is mostly used in Anglo-Saxon countries and "insider-system" that is prevalent in most of Continental European Countries. In addition, there are also two corporate governance models rarely used which can be subordinated as Rhineland (Germanic) and Latin system of the corporate governance models.

In assessment of Turkish evolutionary process and structure of corporate governance system in a broader context, the Capital Markets Boards of Turkey is a key player in determination of legal and institutional framework for corporate governance in Turkey by making considerable contributions to the development process of the corporate governance structure, particularly by issuing Corporate Governance Principles of Turkey. Besides, the establishment of the Capital Market Law also constitutes integral part of the corporate governance legal framework. The legal system of Turkish corporate governance based on "civil law" which is prevalent in Continental Europe as compared to the "common law" which is mostly applied in Anglo-American countries. Within this context, Turkish civil law that constitutes backbone of the corporate governance framework in addition to the Turkish Commercial Code that espoused French civil-law. The fundamental characteristic of the corporate governance structure in Turkey is predominantly based on Family-owned companies which exhibit common features compared to the most European countries, particularly Italy. However the separation of ownership and control is mainly achieved through pyramidal or complex ownership structures. Therefore, it is widely observed in Turkish companies that family ownership takes precedence as a dominant owner at the top of the hierarchy which cascaded through board down and constitutes considerable control over the company's management by exerting a pyramidal structure. Considering basic features and fundamental characteristics of Turkish corporate governance landscape, the corporate governance system of Turkey is often described as the "insider system" country of which the insiders consist of country' s richest families.

In assessment of the position of the European Union in corporate governance that owes its credits to the Lisbon Agenda, including the Lamfalussy and Winter Reports that are fundamental to advancement of the uniquely European approach, which was based on social model concept that occupies significant place of the Lisbon Agenda. It is clearly also known that the EU's social model of corporate governance proffers a number of key priorities in the achievement of good corporate governance practices in the EU. Besides, as has been notably explained in the Lisbon Agenda, good corporate governance brings a number of benefits both at micro and macro level and leads to more investment, growth and sustainable development that constitute integral parts of the Lisbon Strategy. From the abovementioned statements, we can comment that in fulfillment of its main mission the European Commission tries to encourage its Member States for further convergence in promoting its social model, which is mostly seen as most essential part of its competitiveness.

The other important point is to be considered that the EC is the most important key player in the creation of corporate governance regulations and enforceability of the legal context of the EU corporate governance. The EC takes initiatives in the creation of best practices of good corporate governance and strongly encourages its Member States to face remarkable challenges to adopt the European social model of corporate governance in the achievement of sustainable economic growth and competitiveness which were described as key words in the Lisbon Agenda. Within this regard, the EC benefits key instruments such as Directives, Recommendations and Regulations in the creation of best corporate governance practices. It also stimulates and fosters Member States, EU candidate and potential candidate countries in order to better comply with EU corporate governance standards.

In sum, this comprehensive study aimed to deal with Turkish corporate governance landscape by using in depth analysis in a comparative context from point of Turkey's status as a Candidate Country to the European Union membership. Within this context, it has been examined that to what extent Turkish corporate governance regulations need to be developed. Also it has been analyzed that how do the standards of good corporate governance of Turkey compared to the theoretically drive standards of both internationally recognized standards and EU corporate governance standards. Hence, considering Turkey's status as a Candidate Country to the European Union membership, following recommendations have been constituted by using given parameters and the EU 2007 Screening Report on Turkey in order to response current chronic corporate governance problems of Turkey and to better comply with EU corporate governance requirements and recommendations in the context of *acquis communitaire* as well as internationally recognized standards (Screening Report Turkey, 2007:13).

**1. <u>Enhancement of Shareholder Rights:</u>**

Given features concerning the shareholders' activism in Turkey's capital market remains rather poor as compared to the EU (see Chapter 3.4.1). Therefore, shareholder participation to general shareholder meeting in Turkey is relatively low and shareholders do not exert their right to request information. In addition, due to fact that distinctive cultural attitudes and existence of low NGO culture shareholder activism is very low in Turkey. Therefore corporate governance should be really questioned of Turkey in view of EC Directive regarding Shareholder Rights, because of the lack of shareholder culture in Turkey. Besides, due to the high concentration of ownership which is held by family block holders

(controlling shareholder) they can both control the company and monitor the boards. This can lead to a conflict of interest among minority shareholders and large shareholders deriving from pyramidal ownership. Considering Minority Protection Shareholder Index (see Table 3.2) it can be noted that minority shareholder protection also can be observed rather weak in Turkey.

**2. Facilitating the Exercises of Proxy Voting and Necessity of Electronic Voting:**

In order to enhance shareholder rights, in particular in facilitating cross-border voting exercise, the EC's Directive on the exercise of Shareholders' Rights in listed companies strongly recommends timely access to information for shareholders and facility to vote at a distance that was issued in 2007 to be implemented by 2009 (see Chapter 2.2.3). Taking into account attendance to the annual general meetings in Turkey for shareholders which can be made in two ways: personally or by using proxy voting. Since proxy voting procedure entails some documental arrangement leading to high cost proxy voting cannot be exercised in Turkey as compared to the EU Directives (see Chapter 3.4.1). However, considering proxy voting applying and procedure in the EU new European Directive on Shareholders' Rights were developed to remove all barriers and restrictions in front of proxy holders by securing appointment of the proxy holders. Thus, current Turkish Commercial Code and capital market relevant legislation should be changed to comply with the EU Directive on the exercise of Shareholders' Rights. In a nutshell, Turkish voting rules application does not comply with the EC Directive that published to enhance Shareholder Rights within the EU since they (shareholders) are not permitted to proxy vote directly to the company. On the other hand, necessity of electronic-voting and electronic participation for shareholders should be provided as indicated in relevant EU Directives.

**3. Notice of Minimum Period and the Agenda of the General Meeting:**

Taking into consideration the EC's Directive on Shareholders' Rights the notice and agenda of the general meeting has been indicated 21 days before general meetings to vote. If shareholders prefer to vote by electronic means for which this period can be 14 days. However in Turkey, this period has been provided 15 days. In this sense, in the context of EU Directive, the minimum notice period should take place at the TCC of Turkey as emphasized by the EC. In assessing shareholder voting rights in Turkey as compared to the relevant EC

Directives, current TCC and capital market relevant legislation needs to be changed in order to comply with the EC Directive (see Chapter 3.4.1).

**4. Establishment of Independent Board Members and Separation Remuneration and Nomination Committees:**

It has been clearly indicated in the EC Recommendations the necessity of three significant board committees that are well known as nomination, compensation and audit committees whose members with a majority should be independent directors. However in Turkey, in comparison with the EU, there are remuneration and nomination committees that are separated into two units. Also, there is no audit committee with a majority of non-executive independent directors. In parallel to this clarification, the TCC and legal context of capital market does not include any establishment of rules that entails "independent board members" emphasis which is most essential for the existence of effective and good corporate governance. By contrast, the EC Recommendation clearly expresses that the board should have a sufficient number of independent members. In sum, in spite of the fact that, it has been recommended in the CGP of Turkey its implementation is quite weak in comparison with EC Recommendation. Most importantly, given the EU Regulations companies must have an audit committee under the CMB Communiqué that must be composed of at least two non-executive directors. Taking into account independency of the members is not sufficiently considered in the Communiqué. Therefore, it is not compatible with the EU Regulations and Directives.

**5. Development of Disclosure and Transparency:**

It is clearly known that in order to provide disclosure with regard to the corporate governance arrangement within the EU Council Directives *78/660/EEC* on the annual accounts of certain types of companies was amended by Directive *2006/46/EC* in 2006 that required to Member States to disclose of an annual corporate governance statement (see Chapter 3.4.4). Taking into consideration the EU Screening Report on Turkey (2007) clearly expresses that the existing legislation in the field of company law is aligned with the *acquis* to a limited extent. In that sense, it strongly addresses the necessary adjustments to be changed regarding disclosure and publication of financial reports. In addition, according to the EU 2007 Screening Report on Turkey, "Turkey has reached limited level of alignment with the 1st Company Law Directive concerning the disclosure requirements, validity of obligations and grounds for nullity of public and private limited liability companies". Thus, disclosure

requirements should really be improved and disclosure of financial reports needs to be introduced. In a nutshell, to comply with the *acquis* requirements technical infrastructure of company registers operated by the Chambers of Commerce needs to be strengthened.

**6. Audit Independence:**

Taking into consideration EC Recommendations notably encompasses that the role of the CEO and board chairman should be transposed into national law to be applied. In spite of the fact that, it has been recommended in the CGP of Turkey its exercise is rather weak in comparison with EC Recommendation (see Chapter 3.4.5).

This comprehensive study tried to find answer to the question of whether does full membership of Turkey to the EU remedy and overcome existing corporate governance chronic problems of Turkey such as weak law, regulations and shareholder rights by using given parameters and features of both EU and Turkey in a comparative context. In attempt to assess the evolutionary development process of Turkish corporate governance structure it has been started to move forward, in particular after 2000s. In addition, the Capital Market Board of Turkey has made a great deal of contribution by publishing Corporate Governance Principles of Turkey in 2003. Besides, Turkish candidacy status towards an EU full membership created positive financial environment that enabled to Turkey to increase foreign investments and capital flow. In particular, after becoming a candidate for EU membership in 1999, Turkey adopted regulatory reforms to fulfill its legislation within the context of EU accession process (see Table 3.1). Given features pertaining to the Table 3.1 it can be observed that after the 2000/2001 financial crisis the country took further steps to remove drawbacks and negative consequences of the crisis by initiating a number of reforms within the context of Turkey's status as a Candidate Country to the European Union membership. In other words, as the adoption of EU Regulations and Requirements is concerned under the *acquis communitaire* as a candidate country to the European Union Turkey has remained in existence of transformation trend and has gained remarkable economic performance as well as dramatic increase in the number of foreign direct investment entering Turkey.

Considering factors closely affecting and shaping features and characteristics of Turkish corporate governance system one might address that the EU necessary regulations and requirements including recent developments with regard to corporate governance and capital markets that deriving from *acquis communitaire* which is essential part of the EU

integration process. In that sense, Turkey should state availability and relevant regulations in line with corporate governance pertaining to necessary law enforcement and EC Directives would be a proper solution to better comply with EU corporate governance standards. Furthermore, Shareholders' Rights, which is seen chronic problem of the corporate governance structure due to underdeveloped shareholder culture, can be strengthened by the establishment of rules and enforcement as a complement to the strong role of the shareholder activism.

As a consequence, considering challenges of Turkish corporate governance, full membership of Turkey to the EU would remedy by improving the integrity of the judiciary and the legal system and also overcome current corporate governance chronic problems such as weak law, regulations and shareholder rights to some extent. However, some problems cannot be solved only through the establishment of rules and by improving relevant regulations since corporate governance phenomenon consists of a number of key determinants and variables such as cultural, institutional and geographical issues that varies state by state. Thus, management culture, business behavior, economic development, and geographical boundaries should be embodied in a country's corporate governance context as a whole. Therefore, to achieve best practices of corporate governance the focal point of the corporate governance should not be perceived only the integrity of the judiciary and the legal system that constitute a country's corporate governance context. However, Turkey can characterize its own unique corporate governance model by getting benefits from European Union Regulations and Requirements during the European Union accession process. In other words, considering Turkey's status as a Candidate Country to the European Union membership EU necessary regulations and requirements can be cornerstone to boost Turkish corporate governance development and transformation process to a considerable extent.

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I declare that this thesis and the work presented in it are my own and have been generated by me as the result of my own original research.

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