

WHAT GOOD CORPORATE GOVERNANCE PRACTICES CAN TURKEY LEARN FROM THE UK?

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—Abstract—

Globalization has led to an increase in opportunities to make foreign investments. However, some developing countries, such as Turkey, cannot fully benefit from foreign investment. One of the reasons for this is ineffective application of corporate governance. In fact, Turkey can learn a lot from the good practices of developed countries. For instance, the UK has a well established corporate governance framework. First of all, Turkey needs to follow the UK's example in respect of rule making and law enforcement. As a result, principles and the implementations of principles in Turkey would be more efficient.

The principal aim of the paper is to discuss the corporate governance implementation in Turkey and offer some recommendations for improvement. The problems of Turkish Corporate Governance occur because of the ownership structure of Turkish companies, which is mainly family ownership. These problems will be discussed in this paper. Later UK arrangements will be examined and later the following conclusions will be drawn; revising the codes is not done regularly enough in Turkey which inhibits the revision of its codes. Moreover law enforcement is not effective. Besides, ownership structure is not suitable for corporate governance.

Key Words: *Corporate Governance, Turkey, the UK*

JEL Classification: G30

1. Introduction

Countries have to develop their policies to gain the trust of investors to encourage permanent capital. As a result how the board of directors work, their decision-making mechanisms, and their relationships with shareholders is important for investors. Corporate governance (CG) *refers to a set of rules/practices/institutions that minimize agency cost and the divergence between social and private returns on corporate activity* regulates these issues.(Ararat and Ugur,2003:59) CG supports economic efficiency as it focuses on the welfare of the shareholders. The

aim of CG is to make the companies run more profitably and efficiently. In Turkey, CG aims basically to establish a trust relationship between the board of directors (BODs) and the shareholders, protect the rights of minority investors, encourage foreign direct investors to invest. Besides, the UK has a developed CG model, which can be a good example for Turkey with a high level of standards, yet with low cost. Its main application is between boards and shareholders, instead of boards and owner.

This study aims to find out and assess what is missing in implementation of the CG in Turkey and what can be learnt from the UK in respect to CG.

2. Corporate Governance Framework in Turkey

2.1 Corporate ownership and Control Structure

One of the characteristics of Turkish CG is business groups (BGs) which are holding companies; generally include industrial and financial companies. They are controlled by a family or a small group of families. (Yurtoglu,2003:5) Turkish companies have highly centralized ownership structure; families own and monitor nearly 80% of all companies. In most of them the management contains the family members of the company's owners. Holding companies are mostly under direct ownership. Separation of ownership and control is achieved through the pyramid structure and dual class shares. (Yurtoglu,2003:7-8) According to a research, approximately 78% of listed companies are controlled by families. 8% of the remaining are controlled by partially government, partially private owned group of companies such as *Oyak Group*. The remainder are either controlled by foreign companies or by entities similar to foundations. (Yurtoglu,2003:9-10) Generally family members dominate in BODs. The BODs' first aim is control of the company, thereby decreasing risks.(Dinler,2009:2)

One of the main problems of Turkish CG is an 'expropriation problem'. Minority shareholders have difficulties with property rights protection and may suffer abuse of their minority position and contract violations. (Ararat and Ugur,2003:59) Turkey's CG system is an 'insider system'. (Yurtoglu,2000:193-222) The higher concentration of insider ownership means a lower degree of investor protection. As companies are controlled by family members, independent non-executive directors are rare. In family companies, consanguinity is much more important than experience and performance in choosing independent non-executive. Family members are responsible for monitoring the business as a group CEO in the holding structure; they also carry out the role of 'chairman' in individual companies. As with non-executive directors, if families do not choose a CEO

from their family members, he/she will generally be a family acquaintance. (Ararat and Ugur,2003:68) This structure is not appropriate for effective monitoring. As a result, separation of ownership and control becomes more important because professional directors have more knowledge and experience. Furthermore, the decisions that professional directors make for the company will be more effective, especially if they have a global vision. (Eren,2005)

2.2 Legal Framework and Law Enforcement

Turkey is a civil law country. The law affecting the companies, the Commercial Code (CC), was taken from French. A public limited company is the only type of company that can offer shares to the public. Regardless of whether they are open to public, they are governed by CC. The legal provisions do not provide enough shareholder protection, so companies have developed self-regulation to fill the gap. However, because of Turkey's cultural and legal background, the improvements are still not adequate for self-regulation and most companies are reluctant to give detailed information. Minority shareholder protection is more difficult with self-regulation. To protect the stakeholder's rights, regulations should be in force in Turkey.

Application of good CG requires an appropriate legal and management system. The Turkish legal system is complex and costly with weaknesses in the enforcement of law. (Ararat and Ugur,2003:68) Capital Markets Board (CMB) does not have power to rule in the courts. Transparency and shareholder protection are not possible with voluntarily codes. As principles are optionally applied, there is no sanction for companies which do not apply them. Especially in monitoring, code application is very important. If not applied completely, there can be disclosure problems between company managers and investors. The main problem regarding CG is that all the subjects are not treated equally. Decisions made by boards should be equal for related parties and this should be guaranteed by law. The legal backing is weak. The aim of applying CG codes is not to achieve a separated management but to gain an advantage in competition. As a result, there should be some legal reforms to reorganize the legal framework to resolve the confusions.

2.3 Spread of Corporate Governance in Turkey

CG started to become important in Turkey after foreign investors insisted CG be exercised. In international comparative studies, Turkey had received low rankings for transparency, protection of shareholder rights and corruption.

(Bayraktaroglu,2007:245-258) The weak CG structure of Turkey disabled a healthy economy and obstructed a balanced capital market.

The spread started with the CG best practice code published by Turkish Industrialists' and Businesses' Association in December 2002. After that, CMB published the principles, which were similar to OECD principles, in 2003, and revised it in 2005. Nevertheless, because of highly concentrated structure of families, it is difficult to apply the transparency and shareholders principles. Moreover, as families have the highest percentage of shares, they do not want to give up their control to the directors. (Dinler,2009:2) There are 2 main authorities in respect to CG.

2.3.1 Capital Markets Board (CMB) and Istanbul Stock Exchange (ISE)

CMB is the regulatory and supervisory authority in charge of the securities markets in Turkey. The main missions of the Board are to make new regulations; supervise the goal of assuring fairness, efficiency and transparency in Turkish capital markets and improve their international competitiveness. It also sets the operation rules for capital markets and provides protection for shareholders. CMB declared 'The Principles' in 2003. Also, it created a basic source of rules for the application of codes for institutional CG. (CMB of Turkey, 7 July 2010) The economic development of a country can be supported by its capital market and the capital market has to compete within the global financial markets. That is one of the reasons for defining CG principles. The principles' main aim is to encourage the effective functioning of stock markets so that investors may trust more. The CG principles of CMB are very similar to OECD principles. The application of these principles is not binding. However, it is required for companies to disclose the reasons why they were not applied, the conflict of interests resulting from not exactly applying the principles.

ISE is the only stock exchange in Turkey that provides exchange in equities, bonds, private sector bonds, foreign stocks and real estate certificates. ISE was established in 1986 and has administrative autonomy. However, the CMB has to approve its decisions about market regulations.

2.4 Disclosure Infrastructure

CG protects the shareholder's rights. If companies do not disclose their information correctly, shareholders will be misled.(Poroy,2008:20) If transparency and disclosure are not scrupulously applied, shareholders will not be well informed, accountability will be meaningless.(Poroy,2008:23) Transparency

has an important role in investor trust. High investor trust is the basis of a strong capital market.

For all the companies, it is compulsory to disclose their financial tables such as financial statements and cash-flow statements, which are audited by an independent auditing committee. However, because of accounting rules some information is misleading and companies do not always disclose what they are required to disclose. Since the mid-1980s, Turkey has had a low FDI compared to other developing countries. The reason can be the investors' perception of the Turkish CG framework. (Ararat and Ugur,2003:62) One of the reasons for this performance is explained by the reports of PricewaterhouseCoopers: Turkey was the least fourteenth worst country in the world concerning transparency in 2004. Similarly, in the Transparency International's Corruption Perception Index 2009, Turkey scored 4.4 over 10. The score is poor as it is lower than half of the total score.

As the ownership is concentrated, the demand for transparency is low. Nearly all BGs have their own related banks. This is a reason for the lack of strong disclosure tradition in Turkey. (Ararat and Ugur,2003:69) Moreover, disclosure is strongly related to accounting practices. However, there was no generally accepted accounting principle being applied equally to all companies made it difficult to compare them with each other. Today, to orient itself to developed countries, International Accounting Standards (IAS) is applied to all listed joint-stock companies in Turkey. Even though the reforms have a positive effect on disclosure, Turkish companies still fail to disclose non-compulsory information. CMB's low enforcement is also another factor. Even though disclosure is improving, the overall improvement level is slow.

According to a research, more than 60% of companies disclosed information about ownership structure and shareholder rights. Information such as the number of shares, top shareholders and CG principles is disclosed by most of the companies. If there is not any additional cost of disclosure, most companies disclose information. Contrarily, little improvement is seen in some disclosures such as the board nomination processes, voting agreements and top executives' shareholding, as it may require an amendment to the articles of associations.(Ararat,2007:5) Fewer problems occurred in financial transparency and information disclosure after IAS made disclosure of these compulsory for listed companies. 90% of companies disclose information about accounting policy and standards, the auditing report etc. However, there is no requirement to disclose fees paid to auditors for audit work. It is important as it helps the

investors to evaluate external auditors' conflicts of interest.(Ararat,2007:6) Declaration of the remuneration of directors and executives for board and management structure and process, is the weakest part of disclosure in Turkey. Only a few companies disclose information on the process of deciding managers' pay, and whether nomination, remuneration and compensation committees exist. (Ararat,2007:7) Also, holding companies and their subsidiaries have different levels of disclosure and there are still doubts about group transparency. In many of listed companies' boards, there are employees of a controlling parent holding who is a member of the family. (Ararat,2005) They take executive orders from that holding's management with respect to their decisions and can share the financial situation of the subsidiary company with a controlling shareholder.

Disclosing the following are a significant sign of transparency;(Ararat,2007:7-8) The 'related-party' transactions details; Existence of independent or non-executive directors on the board; Information on formal/informal voting agreements; Details of shares; Whether group-wide policies are feasible for subsidiaries.

2.5 Shareholder Protection

Shareholders cannot perform their rights efficiently in Turkey. One of the reasons for poor protection may be insufficient communication between management and shareholders. CMB principles, require *CG committee* in companies and a new *shareholder relations department*, associated with it and a regularly updated website informing the shareholders.(Poroy and Crowther,2008:410) Communication is crucial for shareholders, as they need to be informed before making financial decisions.

Turkey's weak legal framework is another reason. Due to economic and political developments, the regulatory framework could not be improved regarding minority shareholder protection. Structural policies were poor and accessing capital markets was discouraged. Moreover, families dominate the management of companies. So majority shareholders always become more important than minority shareholders; in practice minority shareholders have problems in obtaining disclosed information. One of the most significant rights of minority shareholders is voting rights. In joint stock companies, shareholders effect the decisions by voting. A cumulative vote can only be used when choosing board of control members and management. With this voting system, all shareholders can vote for one or a few certain candidates. It helps minority shareholders to send their candidates to BODs or to canvass their votes on a certain candidate so that they can make a stand against controlling shareholders. In this way, shareholders

have the opportunity of better represented and having their rights better protected. (Kayihan,2005:91) According to the research of the International Institute Finance (IIF), the Turkish regulatory framework does not ensure minority shareholders' rights and investor protection. As it is understood from the results, concentrated ownership is the main problem of investor protection. While deciding on major corporate decisions, the majority of votes are ineffective as in dual share ownership, voting rights can be different for every share. So even if a majority of votes is required, the majority of voting rights will be held by the owners of the company. Shareholders have the right to dismiss the director under Turkish law. Because of that, agents feel responsible to the owners of the company, not to other parties related to the company. However, directors' responsibilities should be regulated not only according to the changing environment of board and members, but also the majority shareholders wants. (Hacımahmutoglu,2007:140-142) Moreover, the remunerations of directors are appointed by shareholders. In family controlled firms, the director is generally a member of the family and director inured by remuneration to benefit the majority shareholders, which are also family members. (IFF,2005:14-15)As the concept of the independent director is relatively new in Turkish CG, the CC does not have any power over independent directors on the boards. However, CMB principles encourage listed companies to have an independent director in their boards and define what is included in the independence. In practice, there is a contradiction here, as in Turkish law the directors, including independents, are elected by majority shareholders but as a result of pyramid structure, the independent director is generally also the director of a subsidiary.

To sum up, the main problem is that the companies are owned by families. Even though it seems like separate ownership and control achieved by the pyramid structure, the control power is still held by the families. As a result of the concentrated ownership, the structure is unsuitable for monitoring. Moreover, non-executive directors are rare in companies. The non-executive directors in companies are generally members of the owner's family. By virtue of their legal background, firms are not ready to apply these principles voluntarily. Communication between shareholders and managers is not strong.

3. The UK Aspect

In the UK, CG development often started after a financial scandal. The UK has a well-diversified shareholder structure. Institutional investors have more effect than individual investors as they bring more liquidity, they have larger shares and influence how the company run. Generally, they have more knowledge about

business than individual investors, which is why they have an important place in the UK CG. Briefly, after some crucial collapses, it is understood that there was a lack of confidence in the financial reporting of many UK companies. As a result, the Committee on Financial Aspects of CG was established in 1991. The report covered best practices in governance, and recommended that all listed companies in the UK should apply a 'comply or explain' mechanism. (Kendall and Kendall,1998:22) After the establishment of the Committee, the Greenbury report, the Combined Code, The Turnbull Committee, Higgs Review was established in order to strengthen the UK CG from various aspects. The current UK CG Code (2010) came into force on 28 May 2010.

For various aspects of CG, such as reporting, auditing, disclosing, and voting, the Companies Act 2006 is crucial. It shows the basic framework of companies. Under the Companies Act 2006, the companies must set out their objectives; it is an offence to give misleading information. (Companies Act,2006) According to the Act, it is a right of shareholders to receive all communications sent by the company. Companies are required to have directors. All details on how to register director and duties of directors are mentioned in the Act. Public companies must conduct an annual general meeting in each period of 6 months and must be announced to the shareholders. Shareholders may require circulation of resolution for Annual General Meetings (AGM). In AGM, the appointment of a director of a public company is voted by shareholders. There are also additional requirements for quoted companies, such as website publication of information about poll results. Shareholders always have the right to request records of resolutions and meetings.

Even though full compliance cannot yet be achieved, the overall compliance rate of CG in UK is increasing. 95% of the companies comply and that they have adopted most of the principles.(Arcot, Bruno, and Faure-Grimaud,2010:11). There are 2 important CG regulatory bodies in the UK.

3.1 Financial Services Authority (FSA) and Financial Reporting Council (FRC)

The FSA is an independent regulatory body of financial services industry in the UK. It has rule-making and enforcement on disclosure and transparency. The firms FSA are required to supply the FSA with information. Institutions falling outside the UK Combined Code are issues of FSA CG Standards.

The FSA announced CG rules in the Financial Services and Market Act (FSMA) 2000 and their duty as an authority to monitor them. (FSA,2010) The disclosure

and transparency rules says that companies must have an auditing committee responsible for monitoring financial processes, internal control and risk management, and the independence of the external audit. In the CG report, the disclosure of which body performs which function must be detailed. It is an obligation to publish the applied practices, the descriptions of the main features of the company's risk management, financial reporting systems, and operation of the company's management and supervisory systems in the CG report.(The Association of Investment Companies,2008)

Financial Reporting Council (FRC) is an independent regulator responsible for promoting CG and reporting in the UK. By contrast to the FSA, the FRC is not a statutory body. The FRC sets standards for reporting. The FRC is working on enhancing and promoting auditing quality. It tries to promote high standards of CG through the UK CG Code. It has standards for corporate reporting, actuarial practice, and monitoring, and carries out accounting and auditing standards.(FRC,2010)

One of the main aims of CG is to maximize the benefit of shareholder and the "Combined Code underlies 'shareholder primacy. (Arcot, Bruno, and Antoine, 2010:80) Codes aim to ensure transparency and strongly advise separate ownership and control. The Combined Code 2010 says that no one individual should have the authority to decide. It is the board's responsibility to ensure the risk is managed in the company. It is advised that the annual report should show how the boards are operated and which decisions are taken by them. (FRC,2010:9-11) The board should ascertain the independent character of non-executive director. In some situations the board should give reasons for why it is thought that the director is independent. For bigger companies, at least half of the board should be constituted of non-executive directors. (FSA,2010:12-17) There should be a satisfactory communication level between shareholders and company directors. For each decision taken, the company should announce the information and make it available on the company web site. (FRC,2010:26)

To sum up, the UK has a good implementation of CG. It can be said that the UK has improved risk management by using CG. Payments are more performance-related and there is an increase in accountability. In the UK, investors are encouraged to ask for any critical information from the directors. As a result, investors may gain more idea about the management of the company and invest according to that.

4. Lessons for Turkey from UK Corporate Governance

Revising and updating is a deficiency in Turkish CG. Despite Turkey having published CG principles in 2003, researches show that in 2006 the situation was *'better than nothing at all'* (Kurt and Kayacan,2007:27). In the UK, the codes are amended regularly. As a result a developed best code is formed for application of companies. When CG principles started to apply in Turkey, the legal background was not developed enough to apply them completely and problems occurred. Turkey has problems in law enforcement. In most of the companies there is not an internal audit committee. There is another auditing type which is a requirement of CC. The CC says that all companies have to record their proceedings and these records must be ready for investigation by Ministry of Industry and Trade. The CC auditing has an important role in shareholder protection but because of slow law enforcement, not all the companies can be investigated on time. That is why this type of auditing in Turkey is a false display just to suit the legal requirement.(Mentes, 2009:158) This makes it more difficult to apply CG as CG has a close relationship with accounting. In the UK, rules and principles not only complete but also strengthen each other. Compared to Turkey, there are more regulations and principles on accounting standards and auditing.

Turkey's traditional ownership structure which is highly concentrated is the main problem of CG. All companies traded on the ISE are public limited companies but nearly all of them are still family companies. They have the power to affect important decisions in the company. A quarter of the top 100 listed companies do not have a shareholders' relations department. (Poroy and Crowther,2008:416) Contrary, the UK has a well-diversified ownership structure and its CG codes encourage the separation of ownership and control. In Turkey, the system especially affects the independence of board members and committees and the protection of minority shareholders. Independent directors are rare in Turkey. In the top 100 listed companies, the rate of companies which do not comprise independent members is 37%. Moreover, 22% of them have only one or a few directors who are family members. (Poroy and Crowther,2008:417) The main reason for not having enough independent BODs could be that finding an experienced and successful director is very costly. In general, shareholders are mostly protected by rules in articles of incorporation but in most companies it is inadequate since articles are prepared by founders. The protection rules are not mentioned in articles of incorporation very clearly and some rules are formed according to their benefits. Here, it is questionable how independent BODs can be and to what extent BODs is able to apply the CG principles. According to 2008 data, only 36 companies traded on ISE-100 have independent BODs.(Poroy and

Crowther,2008:417) In the UK, four years after publication of the Higgs Report, the rate of independent BODs in the FTSE-350 was 96%. (Insight Investor Responsibility) It is believed that an independent member who is away from the internal power of the company will have a positive contribution to company decisions with his objective view.

The main reason of low transparency is also the ownership structure of Turkey. Even though this is the main information that should be determined and announced, 14% of ISE-100 companies have not disclosed its mission and vision. (Poroy and Crowther,2008:418) 77% of the traded companies do not have an information policy which should be prepared by BODs and submitted to the approval of shareholders. Besides, three quarters of the companies do not have a disclosed dividend policy. Moreover, only 31% of companies disclosed whether they apply CG codes in their annual reports. Most of the companies do not use web pages properly for public disclosure.(SPK, Kurumsal Yonetim Uygulama Anketi Sonuclari) It is a listing rule for the companies in the UK to have a good web site disclosure. That is why all companies have their web pages and inform their investors through the internet. The FTSE has announced dividend policy rules on its web page. In Turkey, nearly all holdings have their own banks so they do not need high level transparency for obtaining credit. Nonetheless, disclosure of non-mandatory information is not frequent, and declaration of remuneration is still weak. In the UK, the FRC and FSA are responsible for the disclosure of financial tables. They have the rules of disclosing and what to disclose. Unlike Turkey, disclosure of risk management policy and internal control are mandatory in the UK. Shareholders should be informed about the risk regularly. Unless already established a separate board of risk committee, the auditing committee should be set up not only for controlling financial statements, but also to inform about risk management. In the UK, concentrated ownership is discouraged, investors are generally protected by powerful institutional regulations instead of courts. (Paccos,2009:14) Compared to dual-share, the one share-one vote is compatible with CG because despite having the same value, a dual share gives one investor more voting rights than the other. In Turkey, generally the shares with more voting rights are collected by the families: even though in the CC, it is a rule that every share must have one voting right, dual-share can be allowed by the articles of incorporation. In the UK, dual-share ownership is not allowed. In the listing rules, it is mentioned that every shareholder has a percentage of votes equal to the percentage of shares he/she owns; every share has one voting right. As companies in the UK have nomination committees, it is not very easy to give authority to one group of shareholders. As a result minority shareholders can vote

for the candidate whom they believe will represent them well in the company. In Turkey, minority shareholders do not have effect on decision making, as the families have the majority of power. Even if one-share one-vote is applied, most shares will be held by the families. However, compared to dual-share, one-vote one-share might be more beneficial for minority shareholders.

Another way of protecting shareholders is by the enactment of law. In the UK, there are rules of transparency and disclosure other than CG codes. Even if the company does not apply the codes, it has to obey the other rules. Either way, the shareholders are protected. In Turkey, shareholders face with limitation on ownership, breach of contract, and violation of minority shareholder rights. In family companies, generally the executive director has to render an account to one person. In real public companies, the executive manager is accountable to all the shareholders. That is why, in Turkish companies, executive managers are not the voice of the shareholders or the head of execution actually. Another situation frequently seen in Turkey is, executive managers work in the same company after retiring, they are appointed to the BODs. This can be harmful since firstly, the new director can not apply his own style of managing and secondly, the mistakes of previous management can be repeated. Moreover, when considering the ownership structure in Turkey, the reason for choosing a new director might depend on the relationship between the person and owner, instead of his performance. (Mentes,2009:164-165) Obviously this situation is very advantageous for the controlling shareholder but not for the minorities. In the UK Combined Code, even if the director have a relationship with any of the directors, shareholders or independent bodies, it should be announced in the annual report. Turkish companies especially are not eager to disclose this information. (Mentes,2009:165) Performance-measuring is one of UK CG's strengths. The directors are paid according to their performance. They can be fired because of their poor performance. Also in the UK, there are committees working on monitoring the operation of the Combined Code and its implementation by companies and shareholders. Turkey needs such an application to see whether at least the 'comply or explain' rule is implemented properly.

5. Concluding Remarks

Turkey has a lot to learn about CG applications from developed countries. First of all, the management structure needs to be changed, as it is the main problem of CG. Contrary, the UK is one of the most improved countries regarding CG. The main problem of Turkish CG is that the families still hold most of the shares thereby controlling the companies. First of all, Turkey should diversify shares to

the public like the UK. Separation of ownership and control should be encouraged because only this way can CG be effective and the governance principles be applied efficiently. As in the UK, CG principles should be updated regularly in Turkey. Law enforcement should be improved to encourage CG because principles alone are not enough. In the UK, the FSA and FRC have listing rules which must be applied before being listed in the FTSE. These rules are the basics of auditing and disclosure as they not only support the principles, but also provide investor awareness. In Turkey, the CC and CML should enact more effective rules to support the principles and these rules should complement each other. Shareholder protection is superbly achieved in the UK. The mandatory rules on transparency and disclosure are detailed, and auditing is done by both internal auditors and independent auditing agencies. There are even shareholders relationship departments to keep in contact with shareholders, all well-regulated. Secondly, shareholders should not be protected by articles of association. Instead there should be more effective rules on protection. Shareholders should feel that they are guaranteed under efficient laws. Share types which bestow privilege on voting should not be allowed under company articles. Information should be given to shareholders on time. The use of web sites should be supported by the rules of the CC. Level of disclosing should be increased. Turkish companies should have CG committees, remuneration and nomination boards. CG committees may control the applications of principles within companies. In this way, on the one hand rules and principles can be applied effectively, and on the other hand shareholder protection can be accomplished. A remuneration board is required as payments should be made according to performance. However, these boards are at the advanced level of CG, first Turkey needs to regulate that people follow the basic rules and after that it can establish these committees.

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